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## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9794]

RIN 1545-AM12

Income and Currency Gain or Loss with Respect to a Section 987 QBU

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations that provide guidance under section 987 of the Internal Revenue Code (Code) regarding the determination of the taxable income or loss of a taxpayer with respect to a qualified business unit (QBU) subject to section 987, as well as the timing, amount, character, and source of any section 987 gain or loss. Taxpayers affected by these regulations are corporations and individuals that own QBUs subject to section 987. In addition, published elsewhere in this issue of the **Federal Register**, temporary and proposed regulations (the temporary regulations) are being issued under section 987 to address aspects of the application of section 987 not addressed in these final regulations.

DATES: Effective date: These regulations are effective on December 7, 2016.

Applicability dates: For dates of applicability, see §1.987-11.

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SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2265. Responses to this collection of information are mandatory.

The collection of information in these final regulations is in §§1.987-1(b)(2)(ii), 1.987-1(c)(1)(ii), 1.987-1(c)(1)(iii), 1.987-1(g)(3)(i)(A), 1.987-1(g)(3)(i)(B), 1.987-1(g)(3)(i)(C), 1.987-1(g)(3)(i)(D), 1.987-3(c)(2)(iv)(B), 1.987-9, and 1.987-10(e). This collection of information is required to establish the taxable income or loss of a taxpayer with respect to a QBU subject to section 987, as well as the timing, amount, character, and source of any section 987 gain or loss and the exchange rates used for foreign currency translation purposes.

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

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

## **Background**

This document contains final regulations relating to the determination of the taxable income or loss of a taxpayer with respect to a QBU subject to section 987 of the Code, as well as the timing, amount, character, and source of any section 987 gain or loss. The final regulations also amend existing regulations under sections 861, 985, 988, and 989.

On September 6, 2006, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-208270-86, 71 FR 52876) that proposed new regulations under section 987 (the 2006 proposed regulations) and withdrew proposed regulations under section 987 published on September 25, 1991 (INTL-965-86, 56 FR 48457) (the 1991 proposed regulations). The Treasury Department and the IRS received many written comments in response to the 2006 proposed regulations. After consideration of all the comments, the 2006 proposed regulations, as revised by this Treasury decision, are adopted as final regulations. Temporary regulations (**TD 9795**) and proposed regulations (REG-128276-12) under section 987 are being published contemporaneously with these final regulations.

## **Summary of Comments and Explanation of Revisions**

### **I. Background**

Section 987 generally provides that, when a taxpayer owns one or more QBUs with a functional currency other than the U.S. dollar and such functional currency is different than that of the taxpayer, the taxable income or loss of the taxpayer with respect to each QBU is determined by computing the taxable income or loss of each QBU separately in its functional currency and translating such income or loss at the appropriate exchange rate. Section 987 further requires the taxpayer to make “proper adjustments” (as prescribed by the Secretary) for transfers of property between QBUs having different functional currencies, including by treating post-1986 remittances from each such QBU as made on a pro rata basis out of post-1986 accumulated earnings and by treating section 987 gain or loss as ordinary income or loss and sourcing such

gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.<sup>1</sup> Section 989(b)(4) provides that, “[e]xcept as provided in regulations,” the appropriate exchange rate with respect to a QBU means “the average exchange rate for the taxable year” of the QBU. Additionally, section 989(c)(5) directs the Secretary to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of [subpart J], including regulations . . . providing for the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer) . . . .”

A. 1991 proposed regulations

The 1991 proposed regulations generally provided that the net income of a QBU with a functional currency other than that of the taxpayer was determined annually. Such determination was based on the profit and loss appearing on the QBU’s books and records, adjusted to conform to U.S. tax principles, and translated into the functional currency of the taxpayer using the weighted average exchange rate for the taxable year. The 1991 proposed regulations also provided for the recognition of exchange gain or loss upon a remittance from the QBU’s equity pool. In general, the equity pool consisted of the contributed capital and earnings of the QBU, reduced by remittances, determined in the QBU’s functional currency. The 1991 proposed regulations also provided for a basis pool, which consisted of the basis of the capital and earnings in the equity pool, expressed in the functional currency of the taxpayer.

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<sup>1</sup> The legislative history of section 987 is discussed extensively in the preamble to the 2006 proposed regulations. See 71 FR 52876.

The portion of the basis pool that was attributable to a remittance generally was determined according to the following formula:

$$\frac{\text{Amount remitted in the QBU's functional currency}}{\text{Equity pool in the QBU's functional currency}} \times \text{Basis pool in the taxpayer's functional currency}$$

Under the 1991 proposed regulations, section 987 gain or loss was the difference between the value of the remittance from the QBU, translated into the taxpayer's functional currency at the spot rate on the date of the remittance, and the basis associated with the remittance.

One important consequence of the equity pool paradigm was that all branch equity gave rise to exchange gain or loss, regardless of whether the equity was invested in assets that actually exposed the QBU's owner to currency fluctuations. For example, both cash denominated in the QBU's functional currency and mobile equipment equally gave rise to exchange gain or loss. As a result, under the 1991 proposed regulations, exchange rate changes that, at most, had only an uncertain and remote effect on the economic results experienced by the owner of a QBU gave rise to substantial exchange gains and losses that taxpayers selectively could recognize by strategically timing remittances or causing a termination of the QBU. Given these distortions, the Treasury Department and the IRS withdrew the 1991 proposed regulations and proposed new regulations on September 6, 2006.

B. 2006 proposed regulations

The 2006 proposed regulations adopted a different paradigm referred to as the foreign exchange exposure pool (FEEP) method. In general, the FEEP method

provides that, as under the 1991 proposed regulations, the income of a QBU that is subject to section 987 (a section 987 QBU) is determined by reference to the items of income, gain, deduction, and loss booked to the section 987 QBU in its functional currency, adjusted to reflect U.S. tax principles. Items of income and deduction generally are translated, consistent with the 1991 proposed regulations, into the functional currency of the section 987 QBU's owner at the average exchange rate for the year. However, the basis of certain "historic assets" and the deductions for depreciation, depletion, and amortization of such assets are translated at the historic rates for such assets. Translating these items at historic rates represents a major difference from the 1991 proposed regulations and prevents the imputation of foreign currency gains or losses to such assets. Additionally, the 2006 proposed regulations required the adjusted basis and amount realized with respect to marked assets to be translated using a spot rate, which for assets acquired in a prior taxable year would be the spot rate for the closing balance sheet of the prior taxable year.

Consistent with the 1991 proposed regulations, the FEED method uses a balance sheet approach to determine exchange gain or loss, which is not recognized until the section 987 QBU makes a remittance. Under the FEED method, exchange gain or loss with respect to "marked items" is determined annually but is pooled and deferred until a remittance is made. A marked item generally is defined under the 2006 proposed regulations as an asset (marked asset) or liability (marked liability) that would generate section 988 gain or loss if such asset or liability were held or entered into directly by the owner of the section 987 QBU. The balance sheet approach, together with the use of historic rates for historic items (generally defined as an asset or liability that is not a marked item), allows taxpayers and the IRS to distinguish between items

whose value is highly responsive to changes in the functional currency of the owner and items for which exchange rate changes have no effect on value, or only an uncertain or remote effect that is more appropriately recognized upon a realization event with respect to the item.

The 2006 proposed regulations define a remittance as a net transfer of amounts from a section 987 QBU to its owner during a taxable year, determined in the owner's functional currency. When a section 987 QBU makes a remittance, a portion of the pooled exchange gain or loss is recognized. In general, the amount taken into account equals the section 987 QBU's net unrecognized exchange gain or loss multiplied by the owner's remittance proportion. The owner's remittance proportion generally equals the amount of the remittance divided by the aggregate basis of the section 987 QBU's gross assets reflected on its year-end balance sheet, determined in the owner's functional currency, without reduction for the remittance.

## II. Summary of Comments and Changes

Many comments were received in response to the 2006 proposed regulations. This Part II discusses those comments and the changes made in response to them. Certain comments received in response to the 2006 proposed regulations are addressed in the temporary regulations and are discussed in the preamble to the temporary regulations rather than in this preamble.

### A. General comments regarding the FEED method, including regarding administrability

A number of comments suggested that the FEED method, in particular §§1.987-3 and -4 of the 2006 proposed regulations, would be difficult to administer. Some of those comments expressed a preference to more closely align regulations under section 987 with the financial accounting rules under Accounting Standards Codification, Foreign

Currency Matters, section 830 (ASC 830).<sup>2</sup>

ASC 830 adopts a functional currency paradigm in which assets, liabilities, and operations of a foreign entity are measured using the entity's functional currency<sup>3</sup> and then translated into the reporting currency (generally, the U.S. dollar) of a U.S. enterprise using a current exchange rate.<sup>4</sup> Thus, revenues, expenses, gains, and losses of the foreign entity, translated into U.S. dollars using a weighted average exchange rate for the reporting period, are included in the consolidated profit and loss statement of the U.S. enterprise,<sup>5</sup> and the assets and liabilities of the foreign entity, translated into U.S. dollars using the spot rate on the balance sheet date, are included in the consolidated balance sheet of the U.S. enterprise.<sup>6</sup> Foreign currency "translation" gain or loss of a foreign entity with a functional currency other than the U.S. dollar is determined with respect to all assets and liabilities on the entity's balance sheet at the end of a reporting period and reported in the cumulative translation adjustment (CTA) account. The CTA account is a sub-account in the equity section of the balance sheet.<sup>7</sup> It is not reflected in profit or loss until the occurrence of a sale or a complete or substantially complete liquidation of the entity.<sup>8</sup> ASC 830<sup>9</sup> explains the rationale for

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<sup>2</sup> ASC 830 codifies Financial Accounting Standard No. 52.

<sup>3</sup> The functional currency of a foreign entity is defined in ASC 830 as the currency of the primary economic environment in which the entity operates.

<sup>4</sup> ASC 830-30-45-3.

<sup>5</sup> ASC 830-10-55-10-11, 830-30-45-3.

<sup>6</sup> ASC 830-30-45-3.

<sup>7</sup> ASC 830-30-45-12.

<sup>8</sup> ASC 830-30-40-1.

accounting for translation gain or loss in equity and not income:

Translation adjustments are solely a result of the translation process and have no direct effect on reporting currency cash flows. Exchange rate changes have an indirect effect on the net investment that may be realized upon sale or liquidation, but that effect is related to the net investment and not to the operations of the investee. Prior to sale or liquidation, that effect is so uncertain and remote as to require that translation adjustments arising currently should not be reported as part of operating results.

The treatment of translation gains and losses can be contrasted with the financial accounting treatment of transactions denominated in a currency other than the entity's functional currency. Changes in exchange rates between the functional currency of the foreign entity and the currency in which such transactions are denominated give rise to changes in expected cash flows in the functional currency, resulting in "transaction" gains or losses. The financial accounting rules require the inclusion of transaction gains and losses in net income for the period in which the exchange rate changes occur.<sup>10</sup> The category of foreign currency transactions that give rise to transaction gains and losses under generally accepted accounting principles overlaps considerably with the definition of a section 988 transaction for tax purposes.

Some comments suggested that, in enacting section 987, Congress intended to substantially adopt the financial accounting rules for foreign currency translation for tax purposes. The Treasury Department and the IRS do not find support for this position in the legislative history to section 987 and, to the contrary, find the position belied by the significant discontinuities between section 987 and the financial accounting rules, particularly regarding the recognition of foreign currency gains and losses. Under

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<sup>9</sup> ASC 830-230-45-1.

<sup>10</sup> ASC 830-20-35-1.

Financial Accounting Standard No. 52 (FAS 52), translation gain or loss is deferred in an equity account until a sale or liquidation of the foreign entity, at which point the economic effects of the aggregate translation gain or loss can be measured against a real economic event. The “equity pool” paradigm of the 1991 proposed regulations determined the amount of section 987 gain or loss in a manner that was similar to the determination of translation gain or loss under FAS 52 by imputing foreign currency gain or loss to all assets and liabilities on the balance sheet. In contrast with the accounting rules under FAS 52, however, the translation gain or loss was not sequestered in an equity account but rather was included in income upon a remittance as required by the section 987 statute, making the consequences of imputing foreign currency gain or loss to all assets and liabilities substantially greater.

As expressed in the preamble to the 2006 proposed regulations, the administrative convenience achieved by generally adopting the FAS 52 computational methodology in the 1991 proposed regulations gave rise to many cases in which the section 987 gain or loss taken into account on a remittance deviated substantially from the economic results experienced by the QBU. For example, currency loss was imputed with respect to assets (such as a commercial building or an oil rig) for which, due to the mobility of investment capital or the assets themselves, exchange rate fluctuations would have, at most, only a remote and uncertain effect on asset value. Moreover, because remittances could be funded from other assets, such loss could be recognized without regard to any realization event with respect to the assets that gave rise to the speculative or noneconomic section 987 loss.

Given the inappropriate economic and timing results attributable to adopting the FAS 52 translation methodology in the 1991 proposed regulations and the significant

differences between the purposes of the FAS 52 computation of CTA and the computation of unrecognized section 987 gain or loss, the Treasury Department and the IRS remain of the view that the FAS 52 model is not appropriate for tax purposes. Similarly, the Treasury Department and the IRS have determined that an approach based on consistency with FAS 52 computations modified to address abuses, as suggested in some comments, is inappropriate because such a system would impute foreign currency gain or loss to all assets and liabilities on the balance sheet and generally allow for the recognition of such gains and losses based on remittances without regard to the owner's actual economic exposure to the QBU's functional currency. Rather, the Treasury Department and the IRS have determined that an approach premised on consistency with section 988, modified to take into account administrability and policy considerations unique to section 987, will carry out the purposes of section 987 most appropriately.

Other comments recommended a hybrid approach that would combine the methodology of the 1991 proposed regulations for computing a section 987 QBU's net income with the methodology of the 2006 proposed regulations for computing section 987 gain or loss. Under the proposed hybrid approach, section 987 gain or loss generally would be determined under the method of the 2006 proposed regulations, but taxable income or loss would be translated into the owner's functional currency at the yearly average exchange rate without any adjustments. A consequence of this hybrid approach is that a different exchange rate would be used to translate recovered basis with respect to historic assets in determining taxable income or loss than would be used to translate such basis to determine section 987 gain or loss. These comments generally favored the FEEP method for determining section 987 gain or loss because it

avoids imputing section 987 gain or loss to all assets and liabilities on the balance sheet, as under the 1991 proposed regulations, but asserted that determining taxable income or loss in the functional currency of the section 987 QBU and translating that amount into the owner's functional currency at the yearly average exchange rate without any adjustments is more administrable and more consistent with sections 987(1) and (2) and the legislative history of section 987.

The Treasury Department and the IRS have concluded that the proposed hybrid approach would not achieve the goal of ensuring remittances trigger only "exchange gain or loss inherent in accumulated earnings or branch capital," as contemplated by Congress, and inappropriately would cause offsetting exchange rate effects to be reflected in section 987 taxable income or loss and in the FEED. (H.R. Conf. Rep. No. 99-841, at 675 (1986)). Although a hybrid approach would simplify the calculation of section 987 taxable income or loss, the simplification would cause basis recovery deductions with respect to depreciable and amortizable assets that are included in section 987 taxable income or loss to reflect exchange rate fluctuations with respect to the asset (for which exchange rate fluctuations may have, at most, only a remote and uncertain effect on value). If the asset is retained on the closing balance sheet, the FEED would reflect equal and offsetting exchange rate fluctuations with respect to the asset, to the extent of any accumulated depreciation or amortization that was included in taxable income and translated at current exchange rates. This is because, in determining section 987 gain or loss under §1.987-4 of the 2006 proposed regulations, section 987 taxable income or loss is subtracted from the change in the owner functional currency net value (OFCNV) of the section 987 QBU, which is determined using historic exchange rates for historic items. Accordingly, the distortion in the

determination of section 987 taxable income or loss with respect to historic assets would cause an offsetting distortion in the FEEP.

An example illustrates the equal and offsetting exchange rate effects that can arise with respect to a historic asset under the hybrid approach. Consider the situation of a section 987 QBU (euro QBU) that has the euro as its functional currency and that has an owner that has the dollar as its functional currency. If euro QBU acquires depreciable equipment for €100 on the last day of year 1, when the historic exchange rate is €1 = \$1, and takes into account €10 of depreciation with respect to the equipment in year 2, when the yearly average exchange rate is €1 = \$1.50, the €10 of depreciation would be translated at the year 2 average exchange rate into \$15 under the hybrid approach rather than \$10, as would happen if depreciation were translated at the €1 = \$1 historic rate under the 2006 proposed regulations. As a result, section 987 taxable income of euro QBU is \$5 lower under the hybrid approach than it would be under the 2006 proposed regulations.

In this example, the FEEP, in turn, would be higher by \$5 under the hybrid approach than it would be under the 2006 proposed regulations. This is because, in determining the change to the FEEP for a taxable year, section 987 taxable income is subtracted from the change in OFCNV of euro QBU, which is computed by translating the adjusted basis of historic assets using the historic exchange rate for each asset. For euro QBU, solely with reference to the depreciable equipment, year 2 depreciation causes a \$10 reduction in OFCNV, because in computing the change in OFCNV, the €10 change in equipment basis during year 2 is translated at the €1 = \$1 historic rate (year 2 closing balance sheet of \$90 adjusted basis, less year 1 closing balance sheet of \$100 adjusted basis). In order to compute the change to the FEEP for year 2 with

respect to the depreciable equipment, section 987 taxable income with respect to the equipment is subtracted from the \$10 reduction in OFCNV. Thus, the net effect of the depreciation in the FEEP is to increase section 987 gain reflected in the FEEP by \$5 (negative \$10 change in OFCNV, less \$15 depreciation deduction).

Considering all of these effects together, under the hybrid approach, the appreciation of the euro decreases section 987 taxable income by \$5 and increases section 987 gain reflected in the FEEP by \$5. In other words, the FEEP reflects currency gain or loss with respect to the depreciable asset that is offset by an amount that was included in section 987 taxable income. This effect on the FEEP persists even after the asset is sold.

The Treasury Department and the IRS have determined that the offsetting effects in section 987 taxable income or loss and in the FEEP under the hybrid approach raise concerns similar to the concerns that Congress addressed, albeit in a different context, in enacting section 1092. In particular, section 1092 reflects a policy concern regarding inconsistent timing of recognition of gains and losses from offsetting positions. Under the hybrid approach, the exchange rate effect with respect to historic assets would be reflected in section 987 taxable income or loss to the extent of any cost recovery deductions with respect to those assets, but equal and offsetting amounts would be reflected in the FEEP and would not be recognized until there are remittances. Thus, offsetting effects arising from a single asset would be taken into account at different times. Accordingly, the Treasury Department and the IRS have determined that it would be inappropriate for regulations under section 987 to permit distortions to section 987 taxable income or loss, for the sake of enhancing administrability, that have the effect of causing offsetting amounts of gain or loss to be reflected in the FEEP with respect to

the same asset, where the latter amounts would be recognized only upon voluntary remittances from the QBU. Rather, consistent with the discussion in the preamble to the 2006 proposed regulations, the Treasury Department and the IRS have determined that, in order to carry out the purposes of section 987(3) as indicated by the legislative history, as well as sections 987(1) and (2), and taking into account the authority granted in sections 989(b) and (c), it is appropriate to account for recovered basis for historic assets at the relevant historic rate in determining taxable income or loss of a section 987 QBU. This result could be accomplished by translating recovered basis at the historic rate in the first instance or by translating taxable income or loss determined in the section 987 QBU's functional currency at the yearly average exchange rate and adjusting that amount to properly account for recovered basis, as under the simplified inventory method described in Part II.A.3 of this preamble.

Nonetheless, the Treasury Department and the IRS acknowledge the observations about the complexity and administrability of the 2006 proposed regulations that underlie the recommendation of the hybrid approach. The concerns about offsetting amounts recognized at different times under the hybrid approach would not arise for taxpayers that make the deemed annual termination election set forth in §1.987-8T(d) of the temporary regulations. Accordingly, as described in the preamble to the temporary regulations, a taxpayer that makes the deemed annual termination election may also elect under §1.987-3T(d) to apply the hybrid approach. Additionally, the Treasury Department and the IRS have made several changes in these final regulations in response to comments expressing concern about the complexity and administrability of the 2006 proposed regulations.

In addition to the comments recommending a hybrid approach under which

taxable income would be translated at a single exchange rate without any adjustments, other comments expressed more particular concerns regarding the complexity and administrability of the FEEP paradigm specifically with respect to inventory and certain other high-volume, low-value assets. Comments suggested that treating items that turn over quickly, such as inventory, or that have low value as marked items would facilitate administration and compliance while introducing little distortion into the FEEP calculation. The Treasury Department and the IRS do not agree with these specific recommendations to expand the scope of marked assets, because even assets that turn over quickly or have low-value individually could inappropriately give rise to significant amounts of section 987 gain or loss in the aggregate over time. The Treasury Department and the IRS do, however, acknowledge the general points about complexity and administrability reflected in these suggestions, which are similar to the concerns expressed in the comments recommending the hybrid approach.

In order to reduce complexity and improve administrability, the final regulations modify the 2006 proposed regulations in several significant ways, including by permitting more items to be treated as section 987 marked items, simplifying the treatment of marked items so that net income attributable to such items is translated at the average exchange rate, and simplifying the adjustments that are required to translate basis recovery for historic items at the historic rate. These changes balance the administrability benefits of simplifying the final regulations and bringing them into closer conformity with financial accounting rules against the need to minimize the distortions that would result from permitting taxpayers to include uncertain and remote foreign currency gains and losses in taxable income. In particular, the final regulations allow taxpayers to (a) use the yearly average exchange rate as the historic rate, (b)

treat prepaid expenses and liabilities for advance payments of unearned income as section 987 marked items, (c) apply a simplified method with respect to inventory, and (d) translate both basis recovery and amount realized with respect to marked assets at the yearly average exchange rate. Additionally, as described in the preamble to the temporary regulations, the temporary regulations treat certain section 988 transactions as marked items and permit taxpayers to elect to more closely conform the treatment of certain section 988 transactions entered into by a section 987 QBU with their treatment for financial accounting purposes.

#### 1. Yearly Average Exchange Rate as the Historic Rate

Under §§1.987-1(c)(3)(i) and 1.987-2(d) of the 2006 proposed regulations, the historic rate used to translate the basis of historic assets was the spot rate on the date on which the asset was transferred to, or otherwise acquired by, a section 987 QBU. Thus, when assets were acquired by a section 987 QBU on multiple days during a single taxable year, the 2006 proposed regulations required taxpayers to track multiple historic spot rates. A comment observed that taxpayer systems often only identify the date an asset is placed in service and recommended that taxpayers be permitted to use a yearly average exchange rate in lieu of a spot rate in translating historic items.

The Treasury Department and the IRS agree that using the yearly average exchange rate rather than a spot rate to translate historic items would reduce complexity and improve administrability without introducing significant distortions into the determination of section 987 taxable income or loss or section 987 gain or loss. Accordingly, §1.987-1(c)(3)(i) generally provides that the historic rate is the yearly average exchange rate for the taxable year when a historic asset is acquired, or a historic liability is incurred, by a section 987 QBU. Taxpayers that prefer to use the spot

rate as the historic rate, as under the 2006 proposed regulations, may so elect under §1.987-1(c)(1)(iii). A taxpayer that makes this election is deemed to also make the historic inventory election under §1.987-3(c)(2)(iv)(B) that is described in Part II.A.3 of this preamble.

In addition, to further improve administrability, §1.987-1(c)(3)(iii) permits a section 987 QBU that acquires depreciable or amortizable property in one year and places the asset in service in another year to determine the historic rate for the property based on the date the property is placed in service rather than the year the property was acquired, provided that this convention is consistently applied for all such property attributable to that section 987 QBU.

## 2. Prepaid Expenses and Liabilities Treated as Section 987 Marked Items

Comments suggested that prepaid expenses and liabilities for advance payments of unearned income should be treated as section 987 marked items because they typically have a short duration and often concern small amounts. The Treasury Department and the IRS have determined that treating these items as marked items generally would promote administrability without introducing significant distortions in the determination of section 987 gain or loss. Accordingly, the definition of marked item under §1.987-1(d) includes prepaid expenses and liabilities for an advance payment of unearned income where such items have an original term of one year or less.

## 3. Cost of Goods Sold / Inventory

Under the 2006 proposed regulations, inventory was treated as a historic item. As a result, to determine section 987 taxable income or loss with respect to a section 987 QBU under proposed §1.987-3, cost of goods sold (COGS) had to be translated at a historic spot rate that corresponded to the date the liquidated inventory was acquired

or manufactured. A historic spot rate also had to be used to determine the OFCNV of the QBU under proposed §1.987-4 with respect to inventory that was reflected on the section 987 QBU's year-end balance sheet. For these purposes, the cost basis of inventory purchased for resale generally would have been translated into the owner's functional currency at the spot rate on the date of purchase. With respect to inventory that was manufactured by the section 987 QBU, it would have been necessary to translate individually the various components of COGS at the appropriate historic spot rate for each cost component, resulting in an effective historic rate for manufactured inventory that was a blend of the historic rates applicable to such components. That is, labor, materials and other inventoriable costs would have been translated at the spot rate on the date the cost was incurred or, in the case of depreciation, the date the relevant depreciable asset was acquired. Comments suggested that translating inventoriable costs at their historic spot rates presented significant administrative difficulties. In addition to the comments requesting that certain high volume property be treated as a marked asset, one comment requested that a simplified method be provided to deal with the administrative difficulties in applying the 2006 proposed regulations to inventory.

In response to comments, these final regulations simplify the translation of COGS and ending inventory in two significant ways. First, the use under §1.987-1(c)(3) of the yearly average exchange rate rather than a spot rate as the historic rate will significantly simplify the translation of COGS and ending inventory. This change makes it possible to translate all inventory purchased in a given year, and all costs incurred in the production of inventory in a given year (other than depreciation, which is always translated at the historic rate for the year the depreciated property was acquired or

placed in service, regardless of whether it is an inventoriable cost), using a single exchange rate. Second, §1.987-3(c)(2)(iv)(A) prescribes a simplified inventory method under which (i) COGS is translated into the functional currency of the section 987 QBU's owner at the yearly average exchange rate for the current taxable year with a requirement to make only two discrete adjustments to the translated COGS amount, and (ii) a simplified historic rate is used for purposes of determining the OFCNV under Reg. §1.987-4 for inventory to which the simplified inventory method applies. A taxpayer that prefers the inventory method under the 2006 proposed regulations can elect under §1.987-3(c)(2)(iv)(B) to translate inventoriable costs that are included in COGS or ending inventory at the historic rate for each such cost and, if they wish, can further elect under §1.987-1(c)(1)(iii) to use the spot rate as the historic rate.

a. Translation of COGS under the simplified inventory method

Under the simplified inventory method, a section 987 QBU determines COGS in its functional currency and translates that amount at the yearly average exchange rate for the taxable year rather than translating each inventoriable cost at the appropriate historic rate. Taxpayers applying the simplified inventory method must make two adjustments to COGS described in §1.987-3(c)(3). These adjustments mitigate the consequences of translating COGS at the yearly average exchange rate, as if inventory were a marked asset, rather than translating the inventoriable costs reflected in inventory sold during the taxable year at the appropriate historic rates, as under the 2006 proposed regulations. In particular, the adjustments generally prevent inventory from giving rise to section 987 gain or loss reflected in the FEEP. The adjustments also cause section 987 taxable income or loss to correspond over time to the section 987 taxable income or loss that would have resulted if inventoriable costs were translated at

historic rates.

The first adjustment requires the translated COGS amount to be adjusted to reverse the effect of translating (as part of the translation of COGS) cost recovery deductions treated as inventoriable costs at the current yearly average exchange rate rather than at the appropriate historic rates. For a particular cost recovery deduction, this adjustment is calculated as the portion of the deduction treated as an inventoriable cost, computed in the functional currency of the QBU, multiplied by the amount (whether positive or negative) that is determined by subtracting the yearly average exchange rate at which COGS was translated from the historic rate applicable to the property whose cost is being recovered. For example, in a period in which the functional currency of a section 987 QBU has strengthened against its owner's functional currency, the adjustment would reduce the amount of COGS determined in the owner's functional currency to correspond to the amount that would have been determined if cost recovery deductions that are inventoriable costs had been translated at the historic rate, as other cost recovery deductions are translated. To enhance administrability and respond to comments received, this adjustment is taken into account in determining COGS in full in the taxable year in which the inventoriable cost recovery deductions are allowed, regardless of whether a portion of such costs is capitalized into ending inventory.

The second adjustment required under the simplified inventory method differs for inventory accounted for under the last-in, first-out (LIFO) method and for non-LIFO inventory, to reflect the different cost flow assumptions under these accounting methods. For both non-LIFO and LIFO inventory, the adjustment generally causes the amount of section 987 taxable income or loss taken into account by the owner of a section 987 QBU to correspond over time to the amount that would be taken into

account if inventoriable costs were translated at their respective historic rates rather than at the yearly average exchange rate. For non-LIFO inventory, the adjustment is made on an annual basis with respect to beginning inventory. For LIFO inventory, the adjustment is made only when a LIFO layer is liquidated or partially liquidated.

i. adjustment for non-LIFO inventory

For non-LIFO inventory, the second adjustment required under the simplified inventory method is an adjustment with respect to beginning inventory. The adjustment, which must be made annually, corrects the distortion that arises from translating beginning inventory at the current yearly average exchange rate as part of translating COGS, after the same inventory was translated in the immediately preceding year (when the inventory represented ending inventory in the cost of goods calculation) at the yearly average exchange rate for that year. This adjustment to COGS is calculated as the amount of beginning inventory, computed in the functional currency of the QBU, multiplied by the amount (whether positive or negative) that is determined by subtracting the yearly average exchange rate for the current taxable year from the yearly average exchange rate for the immediately preceding taxable year. For example, in a period in which the functional currency of a section 987 QBU has strengthened against the owner's functional currency, this adjustment would reduce the amount of COGS determined in the owner's functional currency by the difference between beginning inventory translated at the current yearly average exchange rate and at the yearly average exchange rate for the immediately preceding taxable year.

Over time, this adjustment generally causes the owner of a section 987 QBU to take into account the same amount of section 987 taxable income or loss as would have occurred under the 2006 proposed regulations if the yearly average exchange rate had

been used as the historic rate. Additionally, because this adjustment is reflected in section 987 taxable income or loss, which is a component of the §1.987-4 calculation of section 987 gain or loss with respect to the section 987 QBU, the adjustment ultimately has the effect of preventing non-LIFO inventory on the year-end balance sheet from giving rise to section 987 gain or loss, notwithstanding that the historic rate at which it is translated each year is the yearly average exchange rate.

ii. adjustment for LIFO inventory

For LIFO inventory, the second adjustment required under the simplified inventory method is an adjustment with respect to LIFO layers liquidated in whole or part during the year. The adjustment, which must be made only in taxable years in which a LIFO layer is partially or fully liquidated, compensates for the translation of COGS attributable to a liquidated LIFO layer at the current yearly average exchange rate rather than at the historic rate associated with the taxable year in which the inventory layer arose. The adjustment is calculated as the amount of each LIFO layer that has been fully or partially liquidated during the year multiplied by the amount (whether positive or negative) that is determined by subtracting the yearly average exchange rate for the current taxable year from the yearly average exchange rate for the taxable year to which the liquidated layer relates.

As a result of this adjustment, each LIFO layer is treated as having a single historic rate, which is the yearly average exchange rate for the taxable year in which the layer arose.

b. Determination of the OFCNV of inventory under the simplified method

For purposes of determining section 987 gain or loss under §1.987-4 with respect to inventory that is reflected on the section 987 QBU's year-end balance sheet, §1.987-

1(c)(3)(i)(B) provides a simplified historic rate for inventory to which the simplified inventory method applies. Under §1.987-1(c)(3)(i)(B), the simplified historic rate for inventory differs depending on whether the inventory is accounted for under the LIFO method. If the inventory is accounted for under the LIFO method, the historic rate is the average exchange rate for the taxable year in which the relevant LIFO layer arose. If the inventory is accounted for under a non-LIFO method, the historic rate is the average exchange rate for the taxable year for which the determination of the historic rate is relevant. Accordingly, for purposes of determining section 987 gain or loss with respect to non-LIFO inventory reflected on a section 987 QBU's year-end balance sheet, the inventory is translated at the average exchange rate for that taxable year. Thus, although non-LIFO inventory subject to the simplified method is nominally a historic asset, it is translated at a current exchange rate each year similar to a marked asset, but using the yearly average exchange rate rather than the year-end spot rate.

#### 4. Translation Rates Used for the Sale of a Marked Asset by a Section 987 QBU

The 2006 proposed regulations provided special rules for translating the adjusted basis and amount realized upon a disposition of a marked asset. For a marked asset that was held by a section 987 QBU on the first day of a taxable year, the required translation rate for the adjusted basis and amount realized with respect to the asset was the rate used to translate the basis of such asset from the section 987 QBU's functional currency into the owner's functional currency in determining the owner functional currency net value of the section 987 QBU for the preceding taxable year under §1.987-4. For a marked asset acquired during the taxable year, the adjusted basis and amount realized were translated at the spot rate on the date the asset was acquired. In response to general comments on the complexity of administering the 2006 proposed

regulations, and considering the relatively minor distortion that would arise from eliminating these special translation rules, the final regulations do not include a special rule for translating the adjusted basis or amount realized with respect to marked assets. Accordingly, the gain or loss on marked assets generally is determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the yearly average exchange rate for the year of disposition.

**B. Excluded entities**

The 2006 proposed regulations provided that banks, insurance companies, and similar financial entities would not be subject to the regulations. In addition, the 2006 proposed regulations identified leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts as "similar financial entities." A comment requested that the final regulations clarify the meaning of "similar financial entities." Comments also suggested excluding entities from the scope of "similar financial entity" (and therefore making such entities subject to the final regulations) if they primarily engage in transactions with related parties that are not themselves financial entities. A comment noted that it would be anomalous to apply the final regulations with respect to all of the operating entities transacting with a related finance coordination center but not apply the final regulations to the center itself.

The Treasury Department and the IRS agree that the reference to "similar financial entities" in the 2006 proposed regulations is unclear and agree that entities primarily engaged in transactions with related persons that are not themselves financial entities should be subject to the final regulations. Accordingly, §1.987-1(b)(1)(ii) omits the reference to "similar financial entities," and replaces it with specific references to the entities that the 2006 proposed regulations explicitly identified as "similar financial

entities.” Additionally, the exception from the application of the final regulations is revised based on the comment received to not apply (such that the final regulations do apply) to entities that engage in transactions primarily with persons that are related within the meaning of sections 267(b) or 707(b) and that are not themselves entities identified in §1.987-1(b)(1)(ii).

The preamble to the 2006 proposed regulations requested comments on the application of the FEEP method to entities excluded from the scope of the 2006 proposed regulations. The Treasury Department and the IRS are still considering how section 987 should apply to excluded entities and request additional comments regarding the appropriate design of rules applying section 987 to excluded entities in light of the rules contained in these final regulations and the temporary regulations. Until regulations providing rules for applying section 987 with respect to such excluded entities are effective, the excluded entities must use a reasonable method to comply with section 987 and cannot rely on these final regulations.

C. Election to apply section 988 in lieu of section 987

A comment recommended allowing an owner of a section 987 QBU that has a relatively small amount of marked items to elect to not apply section 987 with respect to the QBU and instead to apply section 988 with respect to the items that would be considered marked items of the QBU if section 987 applied. The same comment recommended that the Treasury Department and the IRS consider providing such an election more generally without regard to the relative amount of marked items held by an eligible QBU. The Treasury Department and the IRS have determined that the proposed election would create substantial administrative difficulties for the IRS, particularly given that an electing QBU would maintain books and records in its

functional currency but would determine tax consequences by reference to the functional currency of the owner. Accordingly, the recommendation to allow an election not to apply section 987 has not been adopted.

D. Definition of portfolio stock

Under §1.987-2(b)(2) of the 2006 proposed regulations, stock other than portfolio stock is not attributed to an eligible QBU even if it is reflected on the books and records of the eligible QBU. For this purpose, the 2006 proposed regulations provided that stock is portfolio stock if the owner of the eligible QBU owns (directly, indirectly, or constructively) less than 10 percent of the voting power or value of all classes of stock of the corporation. A comment recommended that this rule be based solely on value because voting power should not be a relevant factor in determining whether items of income, gain, deduction, and loss arising from stock are included in section 987 taxable income or loss. The Treasury Department and the IRS agree with this recommendation, which is reflected in §1.987-2(b)(2).

E. Consistency of attribution rules and QBU concept across subpart J

A comment observed that the 2006 proposed regulations provide rules for attributing assets and liabilities, and items of income or expense, to an eligible QBU and that those rules should apply for purposes of sections 985, 987, and 989 to avoid inconsistencies across subpart J. Accordingly, §1.989(a)-1(d)(3) is revised to provide that the principles of §1.987-2(b) apply in determining whether an asset, liability, or item of income or expense is properly reflected on the books and records of a QBU.

To further enhance consistency, the definition of an eligible QBU in §1.987-1(b)(3) is revised to cross-reference the QBU definition under §1.989-1(a). The 1991 proposed regulations generally would have applied to a QBU within the meaning of

§1.989(a)-1 that has a functional currency different than the functional currency of its owner. The 2006 proposed regulations, in contrast, did not refer directly to the §1.989-1(a) QBU definition. Rather, the 2006 regulations generally defined an eligible QBU as activities that constitute a trade or business as defined in §1.989(a)-1(c) for which a separate set of books and records are maintained. By relying on the definition of a QBU in §1.989(a)-1, as the 1991 proposed regulations did, the final regulations avoid inadvertently introducing inconsistencies across subpart J in the definition of a QBU.

#### F. Offsetting positions

Under §1.987-2(b)(3)(iii)(C) of the 2006 proposed regulations, if a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU was the avoidance of U.S. tax under section 987, the Commissioner could reallocate any item between or among the eligible QBU, its owner, and other persons, entities, or eligible QBUs. One relevant factor identified in the 2006 proposed regulations as indicating tax avoidance as a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU was the presence or absence of an item on such books and records that results in the taxpayer (or a person related to the taxpayer as defined in section 267(b) or 707(b)) having offsetting positions in the functional currency of a section 987 QBU. The “offsetting position” concern might arise, for example, when a home office borrows funds denominated in the functional currency of a section 987 QBU and then lends those funds to its section 987 QBU. Since the intra-taxpayer loan is not recognized, the funding transaction booked to the home office will be a section 988 transaction and the cash booked to the section 987 QBU derived from the funding transaction will be subject to section 987. A comment recommended that the Treasury Department and the IRS restrict the parameters of the

“offsetting position” factor, particularly in the context of banks.

As discussed in Part II.B of this preamble, these regulations do not apply to banks. Accordingly, this comment will be reconsidered when regulations applying section 987 to banks and other financial entities are developed. Outside of the financial entity context, the Treasury Department and the IRS have determined that the “offsetting position” factor in §1.987-2(b)(3)(iii)(C) is necessary to prevent the use of transactions involving offsetting gains and losses to selectively recognize losses without recognition of gain. Accordingly, the recommendation to restrict the parameters of the “offsetting position” factor has not been adopted.

G. Exclusion of ordinary-course transactions from the definition of a transfer

Several comments recommended that transactions entered into between two section 987 QBUs of the same taxpayer, or by a section 987 QBU and its home office, in the ordinary course of business should not be considered “transfers” that are taken into account in determining the amount of a remittance. These comments noted the complexity associated with tracking a large number of ordinary-course transactions and contended that such transactions were not appropriate occasions to recognize section 987 gain or loss.

The Treasury Department and the IRS have determined that it is not feasible to define the parameters of an ordinary-course exception to the definition of a transfer with sufficient clarity to avoid abuse and permit effective enforcement given the potentially high volume and variety of transactions between a section 987 QBU and its home office. More significantly, determining the net transfer to or from a section 987 QBU, without regard to whether transfers occur in the ordinary course of business, is essential for appropriately determining section 987 gain or loss under §1.987-4 because all

transfers affect the OFCNV of the section 987 QBU. Furthermore, the Treasury Department and the IRS have determined that the annual netting convention of §1.987-5, which simplifies the calculation of a remittance relative to the 1991 proposed regulations by taking into account only the net transfer to or from a section 987 QBU during a taxable year, appropriately limits the extent to which ordinary course transactions between a section 987 QBU and its home office give rise to a remittance. Accordingly, the recommendation to include an ordinary-course exception to the definition of transfer has not been adopted.

A comment also recommended that the final regulations permit taxpayers to elect to treat disregarded sales of property and services in the ordinary course of business as regarded transactions. The Treasury Department and the IRS have determined that this recommendation, which would result in income or loss recognition on intra-taxpayer transactions, is inconsistent with the paradigm of section 987 and the entity classification regulations under section 7701. Accordingly, the recommendation has not been adopted.

#### H. Extension of the grouping rules

Section 1.987-1(b)(2)(ii) of the 2006 proposed regulations allows a taxpayer to elect to treat all of its directly owned section 987 QBUs with the same functional currency as a single QBU for purposes of section 987. This rule, however, does not allow different members of a consolidated group to group their section 987 QBUs with the same currency into a single QBU. In the preamble to the 2006 proposed regulations, the Treasury Department and the IRS requested comments on whether a grouping election should be allowed with respect to section 987 QBUs owned by different members of a consolidated group and how this election should be technically

effectuated.

Several comments recommended extending the grouping rules to corporations that file a consolidated return so that a consolidated group could make transfers among section 987 QBUs without causing a remittance. However, based on the comments received, the Treasury Department and the IRS have been unable to reconcile in a satisfactory manner the timing of section 987 gain or loss and section 987 taxable income or loss under the final regulations with the principles of §1.1502-13, including separate entity accounting for consolidated group members. As a result, this recommendation has not been adopted in the final regulations. The Treasury Department and the IRS continue to welcome comments with specific recommendations regarding how grouping of section 987 QBUs owned by different consolidated group members could be achieved in a manner consistent with the consolidated return regulations.

A comment requested an election to group section 987 QBUs that are directly owned with section 987 QBUs that are indirectly owned through section 987 aggregate partnerships. The Treasury Department and the IRS have determined that allowing grouping of directly and indirectly owned section 987 QBUs would be inconsistent with the treatment of transactions between a partnership and its partner (and between eligible QBUs of the partnership and of the partner) as regarded transactions for Federal income tax purposes. Additionally, it is unclear how the treatment of directly and indirectly owned section 987 QBUs as a single section 987 QBU could be reconciled with the general requirement under sections 702 and 703 that a partnership determine its income separately. Due to the uncertainties about how directly and indirectly owned section 987 QBUs could be grouped in a manner consistent with the

principles of subchapter K, the recommendation has not been adopted.

A comment requested that an owner be permitted to elect to group less than all of its section 987 QBUs with the same functional currency. The Treasury Department and the IRS observe that it is possible for an owner to have section 987 gain with respect to some of its section 987 QBUs and section 987 loss with respect to other section 987 QBUs with the same functional currency. In light of this possibility, the Treasury Department and the IRS are concerned that the ability to group section 987 QBUs without the constraint of a consistency requirement for all section 987 QBUs with the same functional currency could inappropriately facilitate the recognition of section 987 losses coupled with the deferral of section 987 gains. Accordingly, the recommendation has not been adopted.

I. Adjustment of the computation of net unrecognized exchange gain or loss for tax-exempt income and non-deductible expenses

Section 1.987-4 of the 2006 proposed regulations provided a seven-step process for determining the unrecognized section 987 gain or loss of a section 987 QBU for a taxable year. Comments noted that this calculation did not take into account the effects of tax-exempt income and non-deductible expenses on a section 987 QBU's cash flows. The comments advised that this omission would introduce distortions into the calculation of unrecognized section 987 gain or loss for a taxable year since these items affect a section 987 QBU's balance sheet. In response to these comments, §1.987-4(d) reflects additional steps in the calculation of unrecognized section 987 gain or loss that account for nondeductible expenses (Step 7) and tax-exempt income (Step 8). Step 7 also now explicitly accounts for foreign taxes claimed as a credit, which must be translated at the same rate at which such taxes were translated under section 986(a).

J. Clarification that the rules of §§1.987-3 and -4 apply for determining the E&P of a corporation

Comments indicated that the 2006 proposed regulations did not clearly specify whether the rules provided for determining section 987 taxable income or loss applied for purposes of determining the earnings and profits of a foreign corporation.

Accordingly, §1.987-3(a) clarifies that a foreign corporation that owns a section 987 QBU must apply §1.987-3 in determining earnings and profits with respect to the section 987 QBU.

K. FEEP annual calculation requirement

Section 1.987-4(a) of the 2006 proposed regulations required the determination of the net unrecognized section 987 gain or loss of a section 987 QBU by the owner annually. In addition, §1.987-9 of the 2006 proposed regulations required the taxpayer to keep annual records that are sufficient to establish each section 987 QBU's section 987 gain or loss. A comment requested elimination of these annual calculations and recordkeeping requirements. The Treasury Department and the IRS remain of the view that the annual calculation and recordkeeping requirements are necessary for IRS examiners to verify taxpayer compliance with the final regulations. Based on its experience examining taxpayer positions that relate to events in prior years, the IRS has determined that contemporaneous recordkeeping and calculation requirements provide a significantly more reliable basis for verifying compliance than calculations performed years after the relevant events, which in many cases would be performed by individuals without direct access to the individuals most familiar with the underlying facts or responsible for producing and maintaining the records. Accordingly, the annual requirements have been retained.

L. Character and source of section 987 gain or loss

Consistent with the 1991 proposed regulations, the 2006 proposed regulations required the owner of a section 987 QBU to determine the character and source of section 987 gain or loss for all purposes of the Code, including for determining the extent to which section 987 gain or loss gives rise to subpart F income. In particular, §1.987-6(b)(2) of the 2006 proposed regulations required the owner to use the asset method under §1.861-9T(g) in the year of a remittance to characterize and source section 987 gain or loss for all purposes by reference to the assets of the section 987 QBU.

A comment recommended an exception that would allow a taxpayer to elect to trace identified amounts of section 987 gain or loss to particular assets or liabilities and to characterize such gain or loss by reference to the income or expense derived (or to be derived) from such items. The Treasury Department and the IRS have determined that tracing section 987 gain or loss to particular assets and liabilities is inconsistent with the FEEP method, which aggregates and pools section 987 gain and loss for all assets and liabilities and for all years prior to a remittance. Accordingly, the Treasury Department and the IRS decline to adopt this comment.

A comment questioned whether section 987(3), which refers to sourcing section 987 gain or loss by reference to post-1986 accumulated earnings, provided a sufficient basis for characterizing section 987 gain or loss as subpart F income. The comment recommended against treating section 987 gain as subpart F income but also recommended that, if it were so treated, the final regulations provide a business needs exception similar to that under section 954(c)(1)(D). Another comment acknowledged the Treasury Department's authority under section 989(c)(5) to characterize section 987

gain as subpart F income but questioned the consistency of the requirement in the 2006 proposed regulations to use the asset method of §1.861-9T to characterize section 987 gain or loss with the reference in section 987(3) to sourcing section 987 gain or loss by reference to post-1986 accumulated earnings. The comment recommended that the character and source of section 987 gain or loss be determined by reference to post-1986 accumulated earnings.

The Treasury Department and the IRS have determined that sourcing and characterizing section 987 gain or loss with direct reference to post-1986 accumulated earnings would give rise to substantial complexity and compliance burdens, including the need to track earnings of a section 987 QBU in separate categories over a long period of time. This approach also presents conceptual difficulties, given that section 987 gain or loss arises from marked assets and liabilities rather than accumulated earnings, and allows for planning opportunities if there are deficits in post-1986 accumulated earnings. The Treasury Department and the IRS continue to believe that, as noted in the preamble to the 2006 proposed regulations, the average tax book value of assets is a reasonable proxy for post-1986 accumulated earnings in the context of section 987. For these reasons, the Treasury Department and the IRS decline to adopt this recommendation. Pursuant to sections 987(3) and 989(c)(5), these regulations follow the approach of the 2006 proposed regulations in requiring the owner to use the asset method of §1.861-9T(g) to characterize and source section 987 gain or loss. The final regulations, however, do clarify that in applying the asset method, an owner must consistently determine the value of a section 987 QBU's assets on the basis of either the tax book value or the fair market value of the assets.

Additionally, given the significant symmetry (other than timing) between the

FEEP paradigm and section 988, the Treasury Department and the IRS have determined that, for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D), it is appropriate for taxpayers to treat section 987 gain or loss that is characterized by reference to assets that give rise to subpart F income as foreign currency gain or loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation (CFC). This policy, which has been adopted in §1.987-6(b)(3), will allow taxpayers to offset a section 987 net loss characterized by reference to assets that give rise to subpart F income against a section 988 net gain, and vice versa, in determining subpart F income. Section 987 gain or loss characterized by reference to assets that give rise to subpart F income is treated as attributable to section 988 transactions not directly related to the business needs of the CFC because the Treasury Department and the IRS have determined that using the asset method of §1.861-9T(g) to characterize and source section 987 gain or loss effectively carries out the purpose of the business needs exclusion of section 954(c)(1)(D). In particular, because the asset method characterizes section 987 gain or loss based on whether assets give rise to subpart F income, section 987 gain or loss will not enter into the determination of foreign personal holding company income to the extent assets of the section 987 QBU do not give rise to subpart F income.

#### M. Partnerships

The 2006 proposed regulations applied to all partnerships based on an approach (the aggregate approach) that treated a partnership as an aggregate of its partners, rather than as an entity separate from its partners. As explained in the preamble to the 2006 proposed regulations, the Treasury Department and the IRS proposed the

aggregate approach because it appropriately determines section 987 gain or loss with respect to partnership assets and liabilities by reference to the functional currencies of the partners that ultimately bear the economic exposure to fluctuations in the exchange rate between their own functional currency and the functional currency of the activities of the partnership. Accordingly, under §§1.989(a)-1(b)(2)(i) of the 2006 proposed regulations, a partnership itself was not treated as a section 987 QBU, but certain activities of a partnership that constituted a trade or business could qualify as a QBU that is an eligible QBU of a partner. Thus, a partner generally was treated as owning an eligible QBU consisting of a share of the assets and liabilities held in the partnership's trade or business. Such an eligible QBU could qualify as a section 987 QBU if it had a functional currency different from that of the partner.

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

The Treasury Department and the IRS acknowledge the concerns expressed about the complexity of applying the aggregate approach in the context of partnerships with partners that are unrelated to each other. Nonetheless, consistent with the comment recommending the aggregate approach for partners with substantial

partnership interests, the Treasury Department and the IRS have determined that it is feasible to administer the aggregate approach with respect to a partnership that is wholly owned by related persons. Moreover, adopting the aggregate approach in that context is important for preventing planning opportunities that would arise if the interposition of a partnership within a group of related parties could significantly alter the results that the group otherwise would experience under section 987 without meaningfully altering the group's economic position. Accordingly, the final section 987 regulations retain the aggregate approach of the 2006 proposed regulations only for so-called "section 987 aggregate partnerships," which are defined in §1.987-1(b)(5) as partnerships for which all of the capital and profits interests are owned, directly or indirectly, by persons that are related within the meaning of section 267(b) or 707(b). The final regulations reflect a conforming amendment to the definition of a QBU at §1.989(a)-1(b)(2)(i)(C), which now provides that a partnership, other than a section 987 aggregate partnership, is a QBU.

The 2006 proposed regulations provided a rule for determining a partner's share of the assets and liabilities of an eligible QBU owned indirectly through a partnership. Specifically, §1.987-7(b) provided that a partner's share of assets and liabilities reflected on the books and records of the eligible QBU must be determined in a manner consistent with how the partners have agreed to share the economic benefits and burdens corresponding to partnership assets and liabilities, taking into account the rules and principles of subchapter K. One comment noted that this rule for allocating assets and liabilities to a partner's indirectly owned section 987 QBU was ambiguous and that the rules and principles of subchapter K do not provide sufficient guidance in this regard. Accordingly, as discussed in the preamble to the temporary regulations, the

temporary regulations provide more specific rules for determining a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership.

As previously discussed in this section, comments recommended that the Treasury Department and the IRS consider adopting an entity approach with respect to partnerships. Under the recommended entity approach, a partnership would have its own functional currency and would apply section 987 with respect to each of its section 987 QBUs to determine its taxable income or loss and section 987 gain or loss in that functional currency. Each partner then would be required to take into account its share of the section 987 taxable income or loss and section 987 gain or loss of the partnership, translated into the partner's functional currency at the average exchange rate for the partner's taxable year.

Although the Treasury Department and the IRS have determined that the aggregate approach is appropriate for applying section 987 to section 987 aggregate partnerships, the Treasury Department and the IRS anticipate that regulations for applying section 987 to other partnerships (non-aggregate partnerships) will be developed under a separate project and may adopt a different approach. Accordingly, the Treasury Department and the IRS request comments describing how an entity approach might apply to non-aggregate partnerships, including comments on (1) whether and how section 987 should apply to marked items denominated in the non-aggregate partnership's functional currency, (2) the information reporting that would be necessary to apply an entity approach, (3) whether a distinction should be made regarding how section 987 applies with respect to partnerships in which significant U.S. partners and CFCs together own more than 50 percent of the capital and profits

interests in the partnership, and (4) the rules that would be needed to coordinate with subchapter K.

#### N. Terminations

Under the 2006 proposed regulations, a section 987 QBU terminates when the activities of the section 987 QBU cease, substantially all of the assets of the section 987 QBU are transferred to its owner, a CFC owner of a section 987 QBU ceases being a CFC, or the owner of the section 987 QBU ceases to exist in a transaction other than certain liquidations and reorganizations described in section 381(a). The preamble to the 2006 proposed regulations requested comments on whether transfers of some or all of the assets of a section 987 QBU from one member of a consolidated group to another member of the group should result in a remittance or termination, respectively. Several comments supported a rule under which a section 351 transfer of some or all of the assets of a section 987 QBU to other members of a consolidated group would not cause a remittance or termination where those assets continue to be held in a section 987 QBU following the transaction.

The Treasury Department and the IRS remain of the view that a transfer of substantially all of a section 987 QBU's assets and liabilities under section 351 should result in a termination under §1.987-8(b)(2) because the owner ceases to be subject to section 987 with respect to the section 987 QBU and has no successor in a section 381(a) transaction. Nonetheless, the Treasury Department and the IRS agree that it is appropriate in certain circumstances to defer section 987 gain or loss that otherwise would be recognized as a result of certain transactions, including terminations, that result in deemed transfers from a section 987 QBU where some or all of the assets of the section 987 QBU continue to be reflected on the books and records of a section 987

QBU in the same controlled group. Additionally, the Treasury Department and the IRS have determined that combinations and separations of section 987 QBUs of the same owner generally should not result in recognition of section 987 gain or loss. As discussed in the preamble to the temporary regulations, the temporary regulations provide rules under which certain section 987 gain or loss that otherwise would be recognized upon a combination, separation, termination, or other event with respect to a section 987 QBU is deferred and recognized upon a subsequent event to the extent assets of the section 987 QBU continue to be reflected on the books and records of a section 987 QBU in the same controlled group. Under these rules, a section 351 transfer of some or all of the assets of a section 987 QBU within a consolidated group generally would not result in recognition of section 987 gain or loss, provided the transferred assets continue to be reflected on the books and records of a section 987 QBU.

Comments recommended eliminating the rule in the 2006 proposed regulations under which a section 987 QBU terminates upon its owner ceasing to be a CFC. The comments indicated that the rule is inconsistent with the policy of subpart F and section 1248. One of the comments questioned the authority under subpart J for such a rule. A comment also recommended that the final regulations eliminate the rule under which a section 987 QBU terminates when it is acquired by a non-CFC from a CFC owner in a reorganization in which the CFC owner goes out of existence but has a successor under section 381(a). The Treasury Department and the IRS acknowledge that the policy concern motivating these rules pertains primarily to situations in which a section 987 QBU ceases to be owned by a CFC but continues to be owned by related persons within the meaning of section 267(b). Accordingly, consistent with section 989(c)(5), a

section 987 QBU will terminate under §1.987-8(b)(3), (b)(4) and (c) only in that circumstance.

Comments indicated that it was unclear under the 2006 proposed regulations whether a check-the-box election to treat a foreign disregarded entity that legally owns a section 987 QBU as a corporation for U.S. tax purposes would cause the section 987 QBU to terminate. To provide greater clarity, Example 6 in §1.987-8(f) illustrates that when a foreign disregarded entity that legally owns a section 987 QBU elects to be treated as a corporation under the check-the-box regulations in §301.7701-3, the section 987 QBU terminates due to the deemed transfer of assets from the section 987 QBU to the owner immediately prior to the deemed transfer of assets from the owner to the transferee corporation under section 351. Additionally, §1.987-2(c)(2)(ii) clarifies that if an asset or liability of a section 987 QBU is sold or exchanged (including in a nonrecognition transaction) for an asset or liability that is not attributable to the section 987 QBU immediately after the exchange (for example, non-portfolio stock deemed to be received in a section 351 exchange), the exchanged asset is treated as transferred from the section 987 QBU to its owner in a disregarded transaction immediately before the exchange. This transfer would be taken into account in determining the amount of the remittance from the section 987 QBU under §1.987-5.

Under the 2006 proposed regulations, a section 987 QBU terminates when its activities cease, such that it no longer meets the definition of an eligible QBU under §1.987-1(b)(3). For administrative convenience, §1.987-8(b)(1) reflects a new provision allowing the owner of a section 987 QBU that ceases its trade or business to continue to treat the section 987 QBU as a section 987 QBU for a reasonable period during the

wind-up of the trade or business, which period may not exceed two years from the date the section 987 QBU ceases its activities carried on for profit.

O. Transition rules

Under the 2006 proposed regulations, a taxpayer that used a reasonable method to comply with section 987 prior to transitioning to the final regulations could choose between the deferral transition method and the fresh start transition method. The deferral transition method generally preserved section 987 gain or loss determined under the taxpayer's prior method, whereas the fresh start method did not.

Under the deferral transition method, a taxpayer would determine section 987 gain or loss under the taxpayer's prior method as if all section 987 QBUs of the taxpayer terminated on the last day of the taxable year preceding the transition date. Such section 987 gain or loss was not recognized but rather was considered as net unrecognized section 987 gain or loss of new section 987 QBUs for purposes of applying section 987 to the taxable year that begins on the transition date. The owner of a section 987 QBU that was deemed terminated under this rule was treated as having transferred all of the assets and liabilities attributable to such section 987 QBU to the new section 987 QBU on the transition date. Exchange rates for translating the amounts of assets and liabilities transferred to the new section 987 QBU were determined with reference to the historic spot rates for such assets and liabilities, adjusted to take into account gain or loss determined on the deemed termination.

Under the fresh start transition method, the same deemed transactions would be deemed to occur as under the deferral transition method, but no section 987 gain or loss would be determined upon the deemed termination. Exchange rates for translating the amounts of assets and liabilities deemed transferred to the new section 987 QBU

were determined with reference to the historic spot rates for such assets and liabilities without adjustment. Accordingly, section 987 gain or loss determined under the owner's prior method was not taken into account. Except to the extent of any previously recognized section 987 gain or loss, the effect of the fresh start method is as if the assets and liabilities on the books and records of a section 987 QBU on the transition date had been the only assets and liabilities held by the QBU from its inception.

The Treasury Department and the IRS received several comments recommending changes to the transition rules under §1.987-10 of the 2006 proposed regulations. One comment recommended that the deferral transition method be eliminated. The comment stated that the availability of two transition methods seemed overly generous to taxpayers and that the fresh start method was sufficient. The comment further noted that the effect of the elections made by taxpayers would be very one-sided in a manner detrimental to the fisc. Another comment recommended that taxpayers be permitted to elect a "true fresh start" method that would translate all assets and liabilities on the first opening balance sheet after the transition at the spot rate on the date of transition and therefore disregard any section 987 gain or loss attributable to the assets and liabilities of the QBU for periods prior to the transition date.

The Treasury Department and the IRS agree with the comment that suggested that the fresh start method is sufficient and that the availability of an election between two different transition methods is unnecessary and detrimental to the fisc. By requiring the translation of assets and liabilities of transitioning QBUs at historic rates, unlike the "true fresh start" method suggested by a comment, the fresh start transition method appropriately takes into account the applicability of section 987 prior to the issuance of final regulations. Allowing an election to use the deferral method would allow taxpayers

with substantial overall section 987 losses determined under their prior method, which may not correspond to economic losses, to preserve those losses while taxpayers with substantial overall section 987 gains determined under their prior method could avoid taking some of those gains into account by using the fresh start method. Such an election effectively would operate as a one-time election for certain taxpayers to reduce Federal income tax liability. Additionally, the Treasury Department and the IRS have determined that there would be considerable administrative difficulty, as well as potential for opportunistic planning, associated with determining the appropriate translation rates for transitioning under the deferral method from a section 987 method other than the method of the 1991 proposed regulations. Accordingly, the final regulations do not include an election to use the deferral method. Additionally, the final regulations do not include an election to use a “true fresh start” method, since that method would fail to account in any way for the applicability of section 987 prior to the transition date with respect to assets and liabilities held by a section 987 QBU on the transition date.

A comment recommended that the final regulations provide further guidance on the application of the fresh start method where a taxpayer cannot trace historic spot exchange rates. In response to this comment, §1.987-10(b)(3) provides that, if a taxpayer cannot reliably determine the historic rate for a particular asset or liability, the historic rate must be determined based on reasonable assumptions consistently applied. In addition, the general rules of §1.987-1(c)(3)(i)(A) and (D) ease this burden by providing that the historic rate for assets and liabilities is the relevant yearly average exchange rate, rather than the spot rate.

A comment recommended that taxpayers be permitted to elect retroactively to

apply the final regulations to all open years. Such an election effectively would operate as one-time election to reduce Federal income tax liability. Additionally, consistent with the discussion in Part II.K of this preamble about the need for contemporaneous recordkeeping, the Treasury Department and the IRS have determined that retroactive application of the final regulations would present significant administrative and compliance difficulties, given that it would be necessary in many cases to make determinations under the final regulations based on facts that may not be readily ascertainable or verifiable in hindsight. Accordingly, this recommendation has not been adopted.

A comment asserted that taxpayers that recognized section 987 gain or loss under the principles of the 1991 proposed regulations may be treated unfairly relative to taxpayers that did not follow those proposed regulations. To address this perceived unfairness, the comment recommended that taxpayers be permitted to elect to include a section 481(a) adjustment to account for the difference between the amount of section 987 gain or loss that was taken into account under the taxpayer's prior method and the amount that would have been determined under the method in the final regulations. As an initial matter, it is not evident to the Treasury Department and the IRS that any inequity could result from a taxpayer's chosen method of applying section 987, given that, in the absence of applicable regulations, taxpayers have been permitted to apply section 987 using any reasonable method. Regardless of any perceived inequity, however, as discussed earlier in this Part II.O of the preamble, the Treasury Department and the IRS have determined that the fresh start transition method is the appropriate method for transitioning section 987 QBUs to the final regulations. Under the fresh start transition method, unrecognized section 987 gain or loss determined under a prior

section 987 method is not taken into account, and marked assets and liabilities reflected on a section 987 QBU's balance sheet on the transition date are translated using a historic rate. These rules, together with the requirement under §1.987-10(d) to adjust unrecognized section 987 gain or loss to prevent double counting, have a similar effect as allowing a section 481(a) adjustment with respect to section 987 gain or loss arising from assets and liabilities reflected on a section 987 QBU's transition date balance sheet. Additionally, it is unclear how a section 481(a) adjustment could apply with respect to section 987 gain or loss arising from assets and liabilities that are no longer on the balance sheet on the transition date, absent a requirement to redetermine section 987 gain or loss as if the final regulations had applied from the inception of the QBU. For the reasons described in Part II.K of this preamble, the Treasury Department and the IRS have determined that such a requirement would be inadministrable. Furthermore, the Treasury Department and the IRS are concerned that an election to compute a full section 481(a) adjustment, like an election to use the deferral method, effectively would operate as a one-time election to reduce Federal income tax liability. Accordingly, for the foregoing reasons, this recommendation has not been adopted.

The Treasury Department and the IRS recognize that certain taxpayers have adopted a section 987 method based on a reasonable application of the 2006 proposed regulations (2006 method). Taxpayers that adopted the 2006 method generally already transitioned to that method in accordance with the principles §1.987-10 of the 2006 proposed regulations. Because the final regulations adopt the 2006 proposed regulations without fundamental changes, it is not necessary or appropriate for taxpayers to transition from the 2006 method to the final regulations under the fresh start method. However, §1.987-10(c)(2) provides rules clarifying how net unrecognized

section 987 gain or loss with respect to a QBU that was subject to the 2006 method is determined under the final regulations. Additionally, because the 2006 proposed regulations required the use of a spot rate for the historic rate and the final regulations specify as a general rule that the historic rate is the yearly average exchange rate, §1.987-10(c)(3) permits taxpayers to use historic rates determined under their prior 2006 method for assets and liabilities reflected on the balance sheet of a transitioning QBU on the transition date.

#### P. Elections

Several elections have been included in the final regulations to mitigate potential complexity or administrative burden associated with complying with these regulations. Section 1.987-1(g) provides rules for making elections. As under the 2006 proposed regulations, elections must be made by the owner and must be made for the first taxable year in which the election is relevant in determining the section 987 taxable income or loss or section 987 gain or loss of the section 987 QBU. Elections may not be revoked or changed without the consent of the Commissioner or his delegate. A revocation will be considered if the taxpayer can demonstrate significantly changed circumstances or other circumstances that demonstrate a substantial non-tax business reason for revoking the election.

A comment recommended that the final regulations allow a taxpayer, without the consent of the Commissioner, to adopt or change the translation conventions for any section 987 QBU acquired from an unrelated person in a transaction that does not cause the QBU to terminate. The Treasury Department and the IRS have determined that requiring Commissioner consent to change an election in this circumstance promotes the ability of the IRS to administer the final regulations and does not create an

undue burden. Accordingly, this recommendation has not been adopted.

With one exception, the elections under the final regulations are made on a QBU-by-QBU basis. As provided under the 2006 proposed regulations and described in Part II.H of this preamble, an owner must make the grouping election described in §1.987-1(b)(2)(ii) with respect to all of its section 987 QBUs that have the same functional currency.

The 2006 proposed regulations described elections made under section 987 as methods of accounting but provided procedures for making and revoking such elections that were inconsistent with treating the elections as methods of accounting. This inconsistency is resolved in the final regulations, which do not follow the 2006 proposed regulations in identifying all section 987 elections as methods of accounting and clarify at §1.987-1(g)(4) that an election under section 987 is not governed by the general rules concerning changes in methods of accounting.

Under §1.987-1(f) of the 2006 proposed regulations, an election was made by attaching a statement to the timely filed tax return for the first taxable year in which the owner intends the election to be effective. If the owner failed to make an election in a timely manner, the owner was considered to have satisfied the timeliness requirement if (1) the owner was able to demonstrate that the failure was due to reasonable cause and not willful neglect; and (2) once the owner became aware of the failure, the owner attached the election as well as a written statement setting forth the reasons for the failure to timely comply to an amended tax return. The Director of Field Operations had 120 days following the filing to respond if it determined that the failure to comply was not due to reasonable cause or if additional time was needed to make a determination. If the Director did not respond to the taxpayer within 120 days of filing, the owner was

deemed to have demonstrated that such failure to timely file was due to reasonable cause.

The Treasury Department and the IRS have determined, in part based on the experience of the IRS in administering other regulations, that the procedures described in the 2006 proposed regulations may inappropriately shift to the IRS a burden that arises in the first instance as a result of a taxpayer's failure to make a timely election. Accordingly, those procedures are not included in the final regulations, and taxpayers who fail to make a timely election may seek relief in accordance with the general rules described in §301.9100-1 for requesting an extension of time to make an election.

Q. Other changes

The final regulations reflect other modifications to the language and structure of the 2006 proposed regulations, as well as the inclusion of additional examples, to enhance clarity. The Treasury Department and the IRS do not intend these changes to be interpreted as substantive changes to the 2006 proposed regulations.

**Special Analyses**

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Accordingly, a regulatory flexibility analysis is not required. This certification is based on the fact that these regulations will primarily affect U.S. corporations that have foreign operations, which tend to be larger businesses. Pursuant to section 7805(f) of the Internal Revenue Code, the NPRM preceding this

regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal authors of these final regulations are Mark E. Erwin, Steven D. Jensen and Sheila Ramaswamy of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Amendment to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

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

Authority: 26 U.S.C. 987, 989(c), and 7805 \* \* \*

Par. 2. Section 1.861-9T is amended by revising paragraph (g)(2)(ii)(A)(1) and adding paragraph (g)(2)(vi) to read as follows:

§1.861-9T Allocation and apportionment of interest expense (temporary).

\* \* \* \* \*

(g) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(A) \* \* \*

(1) Section 987 QBU. In the case of a section 987 QBU (as defined in §1.987-1(b)(2)), the tax book value shall be determined by applying the rules of paragraphs

(g)(2)(i) and (g)(3) of this section to the beginning-of-year and end-of-year functional currency amount of assets. The beginning-of-year functional currency amount of assets shall be determined by reference to the functional currency amount of assets computed under §1.987-4(d)(1)(i)(B) and (e) on the last day of the preceding taxable year. The end-of-year functional currency amount of assets shall be determined by reference to the functional currency amount of assets computed under §1.987-4(d)(1)(i)(A) and (e) on the last day of the current taxable year. The beginning-of-year and end-of-year functional currency amount of assets, as so determined within each grouping, must then be averaged as provided in paragraph (g)(2)(i) of this section.

\* \* \* \* \*

(vi) Effective/applicability date. Generally, paragraph (g)(2)(ii)(A)(1) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987-11(b) a taxpayer applies §§1.987-1 through 1.987-11 beginning in a taxable year prior to the earliest taxable year described in §1.987-11(a), then paragraph (g)(2)(ii)(A)(1) of this section shall apply to taxable years beginning on or after the first day of such prior taxable year.

\* \* \* \* \*

Par 3. Section 1.985-5 is revised to read as follows:

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

(a) In general. This section applies in the case of a taxpayer or qualified business unit (QBU) (including a section 987 QBU (as defined in §1.987-1(b)(2)) changing from one functional currency (old functional currency) to another functional currency (new functional currency). A taxpayer or QBU subject to the rules of this

section shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. Except as otherwise provided in this section, the adjustments shall be made on the last day of the last taxable year ending before the year of change (as defined in §1.481-1(a)(1)). Gain or loss required to be recognized under paragraphs (b), (d)(2), (e)(2), and (e)(4)(iii) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income on the last day of the last taxable year ending before the year of change.

(b) Step 1—Taking into account exchange gain or loss on certain section 988 transactions. The taxpayer or QBU shall recognize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A) through (C)) that, after applying section 988(d), is denominated in terms of or determined by reference to the new functional currency. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (that is, whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988.

(c) Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items. Except as otherwise provided in this section, the new functional currency adjusted basis of property and the new functional currency amount of liabilities and any other relevant items (for example, items described in section 988(c)(1)(B)(iii)) shall equal the product of the old functional currency adjusted basis or liability and the new functional currency/old functional currency spot rate on the last day of the last taxable year ending before the year of change.

(d) Step 3A—Additional adjustments that are necessary when a QBU changes functional currency--(1) QBU changing to a functional currency other than the owner's functional currency--(i) Rule. If a QBU changes its functional currency, and after the change the QBU is a section 987 QBU that is subject to §§1.987-1 through 1.987-11 pursuant to §1.987-1(b)(1), then the adjustments described in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section shall be taken into account for purposes of section 987.

(ii) QBU and the owner had different functional currencies prior to the change. If the QBU and the owner of the QBU had different functional currencies prior to the change and as a result the QBU was a section 987 QBU prior to the change, then the adjustments described in paragraphs (d)(1)(ii)(A) and (d)(1)(ii)(B) of this section shall be taken into account.

(A) Determining new historic rates. The historic rate (as defined in §1.987-1(c)(3)) for the year of change and subsequent taxable years with respect to a historic item (as defined in §1.987-1(e)) reflected on the balance sheet of the section 987 QBU immediately prior to the year of change shall be equal to the historic rate prior to the year of change (that is, a rate that translates the section 987 QBU's old functional currency into the owner's functional currency) divided by the spot rate (as defined in §1.987-1(c)(1)) for translating an amount denominated in the section 987 QBU's old functional currency into the section 987 QBU's new functional currency on the last day of the last taxable year ending before the year of change. For example, if a taxpayer with a U.S. dollar (USD) functional currency owns a section 987 QBU that changes from a British pound (GBP) functional currency to a euro (EUR) functional currency, the historic rate for translating a specific historic item of this section 987 QBU from GBP to USD is 1.50, and the spot rate for translating GBP to EUR on the last day of the last

taxable year before the change is 1.30, then the new historic rate for translating this historic item from EUR to USD is 1.15 (1.50/1.30).

(B) Determining the owner functional currency net value of the QBU on the last day of the last taxable year ending before the year of change under §1.987-4(d)(1)(i)(B).

For purposes of determining the owner functional currency net value of the section 987 QBU on the last day of the last taxable year ending before the year of change under §1.987-4(d)(1)(i)(B) and §1.987-4(e), the section 987 QBU's marked items (as defined in §1.987-1(d)) shall be translated from the section 987 QBU's old functional currency into the owner's functional currency using the spot rate on the last day of the last taxable year ending before the year of change.

(iii) QBU and the taxpayer had the same functional currency prior to the change.

If a QBU that has the same functional currency as a taxpayer changes its functional currency to a new functional currency that is different than the functional currency of the taxpayer, and as a result the taxpayer becomes an owner of a section 987 QBU (see §1.987-1), the taxpayer and section 987 QBU will become subject to section 987 for the year of change and subsequent years.

(2) QBU changing to the owner's functional currency. If a section 987 QBU changes its functional currency to the functional currency of its owner, the section 987 QBU shall be treated as if it terminated on the last day of the last taxable year ending before the year of change. See §§1.987-5 and 1.987-8 for the effect of a termination of a section 987 QBU that is subject to §§1.987-1 through 1.987-11.

(e) Step 3B—Additional adjustments that are necessary when a taxpayer/owner changes functional currency—(1) Corporations. The amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency

paid-in capital shall equal the old functional currency amounts of such items multiplied by the spot rate for translating an amount denominated in the corporation's old functional currency into the corporation's new functional currency on the last day of the last taxable year ending before the year of change. 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 section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the new functional currency at the spot rate.

(2) Collateral consequences to a United States shareholder of a corporation changing to the United States dollar as its functional currency. A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(A)) of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B)) changing its functional currency to the dollar shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change.

(3) Taxpayers that are not corporations. [Reserved].

(4) Adjustments to a section 987 QBU's balance sheet and net accumulated unrecognized section 987 gain or loss when an owner changes functional currency--(i) Owner changing to a functional currency other than the section 987 QBU's functional currency. If an owner of a section 987 QBU, subject to §§1.987-1 through 1.987-11 pursuant to §1.987-1(b)(1), changes to a functional currency other than the functional

currency of the section 987 QBU, the adjustments described in paragraphs (e)(4)(i)(A) through (C) of this section shall be taken into account for purposes of section 987.

(A) Determining new historic rates. The historic rate (as defined in §1.987-1(c)(3)) for the year of change and subsequent taxable years with respect to a historic item (as defined in §1.987-1(e)) reflected on the balance sheet of the section 987 QBU immediately prior to the year of change shall be equal to the historic rate prior to the year of change (that is, a rate that translates the section 987 QBU's functional currency into the owner's old functional currency) divided by the spot rate for translating an amount denominated in the owner's new functional currency into the owner's old functional currency on the last day of the last taxable year ending before the year of change. For example, if a taxpayer that owns a section 987 QBU with a British pound functional currency changes from a U.S. dollar functional currency to a euro functional currency, and the historic rate for translating a specific item of the section 987 QBU from GBP to USD is 1.50 and the spot rate for translating EUR to USD on the last day of the last taxable year before the change is 1.10, then the new historic rate for translating this historic item from GBP to EUR is 1.36 (1.50/1.10).

(B) Determining the owner functional currency net value of the section 987 QBU on the last day of the last taxable year ending before the year of change under §1.987-4(d)(1)(i)(B). For purposes of determining the change in the owner functional currency net value of the section 987 QBU on the last day of the last taxable year preceding the year of change under §§ 1.987-4(d)(1)(i)(B) and 1.987-4(e), the section 987 QBU's marked items shall be translated into the owner's new functional currency at the spot rate on the last day of the last taxable year ending before the year of change.

(C) Translation of net accumulated unrecognized section 987 gain or loss. Any net accumulated unrecognized section 987 gain or loss determined under §1.987-4 shall be translated from the owner's old functional currency into the owner's new functional currency using the spot rate for translating an amount denominated in the owner's old functional currency into the owner's new functional currency on the last day of the last taxable year ending before the year of change.

(ii) Taxpayer with the same functional currency as its QBU changing to a different functional currency. If a taxpayer with the same functional currency as its QBU changes to a new functional currency and as a result the taxpayer becomes an owner of a section 987 QBU (see §1.987-1), the taxpayer and the section 987 QBU shall become subject to section 987 for the year of change and subsequent years.

(iii) Owner changing to the same functional currency as the section 987 QBU. If an owner changes its functional currency to the functional currency of its section 987 QBU, the section 987 QBU shall be treated as if it terminated on the last day of the last taxable year ending before the year of change. See §§1.987-5 and 1.987-8 for the consequences of a termination of a section 987 QBU that is subject to §§1.987-1 through 1.987-11.

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

Example. (i) Facts. FC, a foreign corporation, owns all of the stock of DC, a domestic corporation. The Commissioner granted permission to change FC's functional currency from the British pound to the euro beginning January 1, 2020. The EUR/GBP exchange rate on December 31, 2019, is €1:£0.50.

(ii) Determining new functional currency basis of property and liabilities. The following table shows how FC must convert the items on its balance sheet from the British pound to the euro on December 31, 2019.

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

(iii) Exchange gain or loss on section 988 transactions. Under paragraph (b) of this section, FC will recognize a £50,000 loss (£50,000 current value minus £100,000 historical basis) on the Euro Bond resulting from the change in functional currency because, after the change, the Euro Bond will no longer be an asset denominated in a non-functional currency. The amount of FC's retained earnings on its December 31, 2019, balance sheet reflects the £50,000 loss on the Euro Bond.

(g) Effective/applicability date. Generally, this regulation shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987-11(b) a taxpayer applies §§1.987-1 through 1.987-11 beginning in a taxable year prior to the earliest taxable year described in §1.987-11(a), then this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

Par. 4. Section 1.987-0 is added and §§1.987-1 through 1.987-5 are revised to read as follows:

\* \* \* \* \*

Sec.

1.987-0 Section 987; Table of contents.

1.987-1 Scope, definitions and special rules.

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

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

1.987-4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

1.987-5 Recognition of section 987 gain or loss.

\* \* \* \* \*

**§1.987-0 Section 987; table of contents.**

This section lists captioned paragraphs contained in §§1.987-1 through 1.987-11.

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

- (a) In general.
- (b) Scope of section 987 and definitions.
  - (1) Taxpayers subject to section 987.
  - (2) Definition of section 987 QBU.
  - (3) Definition of an eligible QBU.

- (4) Definition of owner.
- (5) Section 987 aggregate partnership.
- (6) [Reserved].
- (7) Examples illustrating paragraph (b) of this section.
- (c) Exchange rates.
  - (1) Spot rate.
  - (2) Yearly average exchange rate.
  - (3) Historic rate.
- (d) Marked item.
- (e) Historic item.
- (f) [Reserved].
- (g) Elections.
  - (1) In general.
  - (2) Exceptions to the general rules.
  - (3) Manner of making elections.
  - (4) No change in method of accounting.
  - (5) Revocation of an election.

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

- (a) Scope and general principles.
- (b) Attribution of items to an eligible QBU.
  - (1) General rules.
  - (2) Exceptions for non-portfolio stock, interests in partnerships, and certain acquisition indebtedness.
  - (3) Adjustments to items reflected on the books and records.
  - (4) Assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU.
- (c) Transfers to and from section 987 QBUs.
  - (1) In general.
  - (2) Disregarded transactions.
  - (3) Transfers of assets to and from section 987 QBUs owned through section 987 aggregate partnerships.
  - (4) Transfers of liabilities to and from section 987 QBUs owned through section 987 aggregate partnerships.
  - (5) Acquisitions and dispositions of interests in DEs and section 987 aggregate partnerships.
  - (6) Changes in form of ownership.
  - (7) Application of general tax law principles.
  - (8) Interaction with §1.988-1(a)(10).
  - (9) [Reserved].
  - (10) Examples.
- (d) Translation of items transferred to a section 987 QBU.

- (1) Marked items.
- (2) Historic items.

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

- (a) In general.
- (b) Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency.
  - (1) In general.
  - (2) Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency.
  - (3) Determination in the case of a section 987 QBU owned through a section 987 aggregate partnership.
  - (4) [Reserved].
- (c) Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency.
  - (1) In general.
  - (2) Exceptions.
  - (3) Adjustments to COGS required under the simplified inventory method.
  - (d) [Reserved].
  - (e) Examples.

§1.987-4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

- (a) In general.
- (b) Calculation of net unrecognized section 987 gain or loss.
- (c) Net accumulated unrecognized section 987 gain or loss for all prior taxable years.
  - (1) In general.
  - (2) [Reserved].
- (d) Calculation of unrecognized section 987 gain or loss for a taxable year.
  - (1) Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year.
  - (2) Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner.
  - (3) Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU.
  - (4) Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner.
  - (5) Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU.

(6) Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.

(7) Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.

(8) Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any tax-exempt income.

(e) Determination of the owner functional currency net value of a section 987 QBU.

(1) In general.

(2) Translation of balance sheet items into the owner's functional currency.

(f) [Reserved].

(g) Examples.

#### §1.987-5 Recognition of section 987 gain or loss.

(a) Recognition of section 987 gain or loss by the owner of a section 987 QBU.

(b) Remittance proportion.

(c) Remittance.

(1) Definition.

(2) Day when a remittance is determined.

(3) Termination.

(d) Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year.

(e) Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year.

(f) Determination of owner's adjusted basis in transferred assets.

(1) In general.

(2) Marked asset.

(3) Historic asset.

(g) Example.

#### §1.987-6 Character and source of section 987 gain or loss.

(a) Ordinary income or loss.

(b) Character and source of section 987 gain or loss.

(1) In general.

(2) Method required to characterize and source section 987 gain or loss.

(3) Coordination with section 954.

(c) Examples.

#### §1.987-7 Section 987 aggregate partnerships.

- (a) In general.
- (b) [Reserved].
- (c) Coordination with subchapter K.

#### §1.987-8 Termination of a section 987 QBU.

- (a) Scope.
- (b) In general.
  - (1) Trade or business ceases.
  - (2) Substantially all assets transferred.
  - (3) Owner no longer a CFC.
  - (4) Owner ceases to exist.
- (c) Transactions described in section 381(a).
  - (1) Liquidations.
  - (2) Reorganizations.
- (d) [Reserved].
- (e) Effect of terminations.
- (f) Examples.

#### §1.987-9 Recordkeeping requirements.

- (a) In general.
- (b) Supplemental information.
- (c) Retention of records.
- (d) Information on a dedicated section 987 form.

#### §1.987-10 Transition rules.

- (a) Scope.
- (b) Fresh start transition method.
  - (1) In general.
  - (2) Application of §1.987-4.
  - (3) Determination of historic rate.
  - (4) Example.
- (c) Transition of section 987 QBUs that applied the method set forth in the 2006 proposed section 987 regulations.
  - (1) In general.
  - (2) Application of §1.987-4.
  - (3) Use of prior historic rate.
  - (4) Example.
- (d) Adjustments to avoid double counting.
- (e) Reporting.
  - (1) In general.

(2) Attachments not required where information is reported on a form.

§1.987-11 Effective/applicability date.

(a) In general.

(b) Application of these regulations to taxable years beginning after December 7, 2016.

(c) Transition date.

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

(a) In general. These regulations under section 987 (§§1.987-1 through 1.987-11) provide rules for determining the taxable income or loss of a taxpayer with respect to a section 987 QBU (as defined in paragraph (b)(2) of this section). Further, these regulations provide rules for determining the timing, amount, character, and source of section 987 gain or loss recognized with respect to a section 987 QBU. This section addresses the scope of these regulations and provides certain definitions, special rules, and the procedures for making the elections provided for in the regulations. Section 1.987-2 provides rules for attributing assets and liabilities and items of income, gain, deduction, and loss to an eligible QBU. It also provides rules regarding the translation of items transferred to a section 987 QBU. Section 1.987-3 provides rules for determining and translating the taxable income or loss of a taxpayer with respect to a section 987 QBU. Section 1.987-4 provides rules for determining net unrecognized section 987 gain or loss. Section 1.987-5 provides rules regarding the recognition of section 987 gain or loss. It also provides rules for determining an owner's basis in assets transferred from a section 987 QBU. Section 1.987-6 provides rules regarding the character and source of section 987 gain or loss. Section 1.987-7 provides rules with respect to section 987 aggregate partnerships. Section 1.987-8 provides rules regarding the termination of a section 987 QBU. Section 1.987-9 provides rules

regarding the recordkeeping required under section 987. Section 1.987-10 provides transition rules. Section 1.987-11 provides the effective/applicability date of these regulations.

(b) Scope of section 987 and definitions--(1) Taxpayers subject to section 987--(i) In general. Except as provided in paragraphs (b)(1)(ii) and (b)(6) of this section, an individual or corporation is subject to these regulations under section 987 if such person is an owner (as defined in paragraph (b)(4) of this section) of an eligible QBU (as defined in paragraph (b)(3) of this section) that is a section 987 QBU (as defined in paragraph (b)(2) of this section).

(ii) Inapplicability to certain entities. Except as otherwise provided in paragraph (b)(1)(iii) of this section, these regulations under section 987 do not apply to specified entities described in this paragraph (b)(1)(ii), other than specified entities that engage in transactions primarily with related persons within the meaning of section 267(b) or section 707(b) that are not themselves specified entities. For this purpose, specified entities means banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, or real estate investment trusts. Further, except as otherwise provided in paragraph (b)(1)(iii) of this section, these regulations do not apply to trusts, estates, S corporations, and partnerships other than section 987 aggregate partnerships (as defined in paragraph (b)(5) of this section).

(iii) [Reserved].

(2) Definition of a section 987 QBU--(i) In general. A section 987 QBU is an eligible QBU (as defined in paragraph (b)(3) of this section) that has a functional currency different from its direct owner. A section 987 QBU also includes the assets and liabilities of an eligible QBU that are considered under paragraph (b)(5)(ii) of this

section to be a section 987 QBU of a partner in a section 987 aggregate partnership (as defined in paragraph (b)(5) of this section). A section 987 QBU will continue to be treated as a section 987 QBU of the owner until a sale or other termination of the section 987 QBU as described in §1.987-8(b). Except as provided in paragraph (b)(2)(ii) of this section, the functional currency of an eligible QBU shall be determined under §1.985-1.

(ii) Section 987 QBU grouping election--(A) In general. Except as provided in paragraph (b)(2)(ii)(B) of this section, an owner may elect to treat, solely for purposes of section 987, all section 987 QBUs with the same functional currency that it directly owns as a single section 987 QBU.

(B) Special grouping rules for section 987 QBUs owned indirectly through a section 987 aggregate partnership. An owner may elect to treat all section 987 QBUs with the same functional currency owned indirectly through a single section 987 aggregate partnership (as defined in paragraph (b)(5) of this section) as a single section 987 QBU. An owner may not treat section 987 QBUs as a single section 987 QBU if such QBUs are owned indirectly through different section 987 aggregate partnerships. Additionally, an owner may not treat section 987 QBUs that are owned both directly and indirectly through a section 987 aggregate partnership as a single section 987 QBU.

(3) Definition of an eligible QBU--(i) In general. Eligible QBU means a qualified business unit, as defined in §1.989(a)-1, that is not subject to the Dollar Approximate Separate Transactions Method rules of §1.985-3.

(ii) Exclusion of certain entities. A corporation, partnership, trust, estate, or entity disregarded as an entity separate from its owner for Federal income tax purposes as

described in §301.7701-2(c)(2) (hereafter referred to as a “DE”) is not an eligible QBU (even though such an entity may have activities that qualify as an eligible QBU).

(4) Definition of owner. For purposes of these regulations under section 987, an owner is any person having direct or indirect ownership in an eligible QBU. Only an individual or corporation may be an owner of an eligible QBU. The term owner for section 987 purposes does not include an eligible QBU. For example, a section 987 QBU (QBU1) is not an owner of another section 987 QBU (QBU2) even if QBU1 owns the stock of QBU2.

(i) Direct ownership. An individual or a corporation is a direct owner of an eligible QBU if the individual or corporation is the owner for Federal income tax purposes of the assets and liabilities of the eligible QBU.

(ii) Indirect ownership. An individual or corporation that is a partner in a section 987 aggregate partnership (as defined in paragraph (b)(5) of this section) and is allocated, under §1.987-7, all or a portion of the assets and liabilities of an eligible QBU of such partnership is an indirect owner of the eligible QBU.

(5) Section 987 aggregate partnership--(i) In general. A partnership is a section 987 aggregate partnership if:

(A) All of the interests in partnership capital and profits are owned, directly or indirectly, by persons related to each other within the meaning of sections 267(b) or 707(b). For purposes of this paragraph (b)(5), ownership of an interest in partnership capital or profits is determined in accordance with the rules for constructive ownership provided in section 267(c), other than section 267(c)(3); and

(B) The partnership has one or more eligible QBUs, at least one of which would be a section 987 QBU with respect to a partner if the partner owned the eligible QBU directly.

(ii) Section 987 QBU of a partner. The assets and liabilities of an eligible QBU owned through a section 987 aggregate partnership and allocated to a partner under the principles of §1.987-7(b) are considered to be a section 987 QBU of such partner if the partner has a functional currency different from that of the eligible QBU.

(iii) Certain unrelated partners disregarded. In determining whether a partnership is a section 987 aggregate partnership, the interest of an unrelated partner shall be disregarded if the acquisition of such interest has as a principal purpose the avoidance of this paragraph (b)(5).

(6) [Reserved].

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

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

(ii) Analysis. (A) Pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of Business A because it is the owner of the assets and liabilities of Business A. Because Business A is an eligible QBU with a functional currency that is different from the functional currency of its owner, U.S. Corp, Business A is a section 987 QBU (as defined in paragraph (b)(2) of this section). As a result, U.S. Corp and its section 987 QBU, Business A, are subject to section 987.

(B) Holding the stock of FC and pounds and servicing a liability does not constitute a trade or business within the meaning of §1.989(a)-1(c). Because the activities of DE1 do not constitute a trade or business within the meaning of §1.989(a)-1(c), such activities are not an eligible QBU. In addition, pursuant to paragraph (b)(3)(ii) of this section, DE1 itself is not an eligible QBU. As a result, neither DE1 nor its activities qualify as a section 987 QBU of U.S. Corp. Therefore, neither the activities of DE1 nor DE1 itself is subject to section 987. For the foreign currency treatment of payments on DE1's pound-denominated liability, see §1.988-2(b).

Example 2. (i) Facts. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. The only activities of DE1 are Business A activities and holding the interests in DE2. DE2 owns Business B and Business C. For purposes of this example, Business B does not maintain books and records that are separate from its owner, DE2. Instead, the activities of Business B are reflected on the books and records of DE2, which are maintained in Japanese yen. In addition, Business C has the U.S. dollar as its functional currency, maintains books and records that are separate from the books and records of DE2, and is an eligible QBU.

(ii) Analysis. (A) Pursuant to paragraph (b)(3)(ii) of this section, DE1 and DE2 are not eligible QBUs. Pursuant to paragraph (b)(3)(i) of this section, the Business B and Business C activities of DE2, and the Business A activities of DE1, are eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, DE1 is not the owner of the Business A, Business B, or Business C eligible QBUs, and DE2 is not the owner of the Business B or Business C eligible QBUs. Instead, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of the Business A, Business B, and Business C eligible QBUs.

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

(C) The Business C eligible QBU has the same functional currency as U.S. Corp. Therefore, the Business C eligible QBU is not a section 987 QBU.

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

(ii) Analysis. (A) Pursuant to paragraph (b)(3)(ii) of this section, DE1 is not an eligible QBU. Moreover, pursuant to paragraph (b)(4) of this section, DE1 is not the owner of the Business A or Business B eligible QBUs. Instead, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of the Business A and Business B eligible QBUs.

(B) Business A and Business B constitute two separate eligible QBUs, each with the euro as its functional currency. Accordingly, Business A and Business B are section 987 QBUs of U.S. Corp. U.S. Corp may elect to treat Business A and Business B as a single section 987 QBU pursuant to paragraph (b)(2)(ii)(A) of this section. If such election is made, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp would be the direct owner of the Business AB section 987 QBU that would include the activities of both the Business A section 987 QBU and the Business B section 987 QBU. In addition, pursuant to paragraph (b)(4) of this section, DE1 would not be treated as the owner of the Business AB section 987 QBU.

**Example 4.** (i) Facts. U.S. Corp owns all the stock of Y, a U.S. corporation that is a member of U.S. Corp's consolidated group. U.S. Corp also owns all the stock of CFC, a controlled foreign corporation (as defined in section 957(a)) of U.S. Corp with the Japanese yen as its functional currency. Y and CFC are the only partners in P, a foreign partnership. P owns DE1 and Business A. DE1 owns Business B.

(ii) Analysis. (A) Under paragraph (b)(5)(i) of this section, P is a section 987 aggregate partnership because Y and CFC own all the interests in partnership capital and profits, Y and CFC are related within the meaning of section 267(b), and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Pursuant to paragraph (b)(3)(ii) of this section, P and DE1 are not eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, for purposes of section 987, neither P nor DE1 is the owner of the Business B eligible QBU, and P is not the owner of the Business A eligible QBU. Instead, pursuant to paragraph (b)(4)(ii) of this section, Y and CFC are indirect owners of the Business A eligible QBU and the Business B eligible QBU to the extent they are allocated the assets and liabilities of such businesses under §1.987-7.

(B) Because Business A and Business B are eligible QBUs with different functional currencies than Y, the portions of Business A and Business B allocated to Y under §1.987-7 are section 987 QBUs of Y.

(C) Because the Business A eligible QBU has a different functional currency than CFC, the portion of Business A that is allocated to CFC under §1.987-7 is a section 987

QBU, and CFC and its section 987 QBU are subject to section 987. Because the Business B eligible QBU has the same functional currency as CFC, the portion of Business B that is allocated to CFC under §1.987-7 is not a section 987 QBU of CFC.

Example 5. (i) Facts. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. DE2 owns Business B and all of the interests in DE3, an entity disregarded as an entity separate from its owner. DE3 owns Business C, which is an eligible QBU with the Russian ruble as its functional currency.

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

(c) Exchange rates. Solely for purposes of section 987, the following definitions shall apply.

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

(ii) Election to use a spot rate convention--(A) In general--spot rate convention. An owner may elect to use a spot rate convention that reasonably approximates the spot rate determined in paragraph (c)(1)(i) of this section in lieu of such spot rate. A spot rate convention may be determined with respect to a spot rate at the beginning of a reasonable period, the end of a reasonable period, as an average of spot rates for a reasonable period, or by reference to spot and forward rates for a reasonable period. For this purpose, a reasonable period shall not exceed three months. For example, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate for all

transactions during a monthly period can be determined pursuant to one of the following conventions: the spot rate at the beginning of the current month or at the end of the preceding month; the monthly average of daily spot rates for the current or preceding month; or an average of the beginning and ending spot rates for the current or preceding month. Similarly, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate can be determined pursuant to an average of the spot rate and the 30-day forward rate on a day of the preceding month. Use of a spot rate convention that is consistent with the convention used for financial accounting purposes is presumed to reasonably approximate the rate in paragraph (c)(1)(i) of this section. The Commissioner can rebut this presumption if the Commissioner determines that the use of the convention would not clearly reflect income based on the facts and circumstances available at the time of the election.

(B) [Reserved].

(iii) Election to use spot rates in lieu of yearly average exchange rates. A taxpayer may elect under this paragraph (c)(1)(iii) to use spot rates in lieu of yearly average exchange rates (as defined in paragraph (c)(2) of this section) for certain purposes. In particular, a taxpayer that makes this election must use the spot rate for purposes of determining the historic rate, as provided in paragraph (c)(3)(ii) of this section, and for purposes of translating items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency, as described in §1.987-3(c)(1). Additionally, a taxpayer that makes this election will be deemed also to elect to use the historic inventory method described in §1.987-3(c)(2)(iv)(B).

(2) Yearly average exchange rate. For purposes of section 987, the yearly average exchange rate is a rate that represents an average exchange rate for the

taxable year (or, if the relevant period is less than a full taxable year, such portion of the taxable year) computed under any reasonable method. For example, an owner may determine the yearly average exchange rate based on a daily, monthly or quarterly averaging convention, whether weighted or unweighted, and may take into account forward rates for a period not to exceed three months. Use of an averaging convention that is consistent with the convention used for financial accounting purposes is presumed to be a reasonable method. The Commissioner can rebut this presumption if the Commissioner determines that the use of the convention would not have been expected to clearly reflect income based on the facts and circumstances available at the time of the election.

(3) Historic rate--(i) In general. Except as otherwise provided in these regulations, the historic rate is determined as described in paragraphs (c)(3)(i)(A) through (E) of this section.

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

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

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

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

(E) [Reserved].

(ii) Historic rate when an election to use spot rates in lieu of yearly average exchange rates is in effect. A taxpayer that has elected under paragraph (c)(1)(iii) of this section to use spot rates in lieu of yearly average exchange rates must determine historic rates under paragraphs (c)(3)(i)(A) and (c)(3)(i)(D) of this section using the spot rate (as defined in paragraph (c)(1) of this section) for the date an asset is acquired by a section 987 QBU or a liability is assumed or incurred by a section 987 QBU in lieu of using the yearly average exchange rate.

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

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

(d) Marked item. A marked item is an asset (marked asset) or liability (marked liability) that is properly reflected on the books and records of a section 987 QBU under §1.987-2(b) and that--

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

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

(3) [Reserved].

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

(f) [Reserved].

(g) Elections--(1) In general. This paragraph (g) provides rules for making elections under section 987. Except as otherwise provided in paragraph (g)(2) of this section, such elections--

(i) May be made separately for each section 987 QBU;

(ii) Are made by the owner of the section 987 QBU (as defined in paragraph (b)(4) of this section); and

(iii) Must be made for the first taxable year in which the election is relevant in determining the section 987 taxable income or loss, or section 987 gain or loss, of the section 987 QBU and in which the regulations implementing the election are applicable with respect to the section 987 QBU.

(2) Exceptions to the general rules--(i) Consistency and timeliness requirements for certain elections. Notwithstanding paragraph (g)(1)(i) of this section, the following consistency and timeliness requirements apply:

(A) Section 987 grouping election. Elections made pursuant to paragraph (b)(2)(ii) of this section (regarding the grouping of section 987 QBUs) are binding on all section 987 QBUs that are eligible to be grouped under the particular election (for example, election to group all euro QBUs owned by the same aggregate partnership), regardless of whether the section 987 QBU is established or acquired after the election is made and regardless of whether the section 987 QBU is identified on the election as required in paragraph (g)(3)(i)(A) of this section.

(B) [Reserved].

(ii) Persons making elections for QBUs owned by foreign corporations. Notwithstanding paragraph (g)(1)(ii) of this section, if a section 987 QBU is owned by a foreign corporation, elections shall be made in accordance with §1.964-1(c) by the foreign corporation's controlling domestic shareholders, as defined under §1.964-1(c)(5)(i) (dealing with controlled foreign corporations) and §1.964-1(c)(5)(ii) (dealing with noncontrolled section 902 corporations).

(3) Manner of making elections--(i) Election made by attaching statement to a return. Except as provided in paragraph (g)(3)(ii) of this section, elections shall be made under section 987 for each section 987 QBU by attaching a statement with the information required in this paragraph (g)(3)(i) to the timely filed tax return of the owner or, in the case of a foreign corporation, other applicable person for the first taxable year in which the election is required to be made under paragraph (g)(1)(iii) of this section.

(A) Section 987 grouping election. The election provided in paragraph (b)(2)(ii) of this section must be titled “Section 987 Grouping Election Under §1.987-1(b)(2)(ii)” and provide the following information:

(1) The name, address, and functional currency of each section 987 QBU that the taxpayer is grouping together; and

(2) The owner’s name and address.

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

(1) A description of the convention; and

(2) The name and address of each section 987 QBU for which the election is being made.

(C) Election to use spot rates in lieu of yearly average exchange rates. An election under paragraph (c)(1)(iii) of this section to use spot rates in lieu of yearly average exchange rates must be titled “Section 987 Election to Use Spot Rates in Lieu of Yearly Average Exchange Rates Under §1.987-1(c)(1)(iii)” and provide the following information:

(1) A description of the convention; and

(2) The name and address of each section 987 QBU for which the election is being made.

(D) Election to use the historic inventory method. An election under §1.987-3(c)(2)(iv)(B) to use the historic inventory method shall be titled “Section 987 Election to Use the Historic Inventory Method Under §1.987-3(c)(2)(iv)(B)” and must provide the name and address of each section 987 QBU for which the election is being made.

(ii) Election made by filing a dedicated section 987 form. If the Commissioner publishes a form that provides the manner in which elections are made under section 987, the form shall govern the manner in which elections are made under section 987.

(4) No change in method of accounting. An election under section 987 is not governed by the general rules concerning changes in methods of accounting. See also paragraph (g)(5) of this section.

(5) Revocation of an election. Elections under section 987 may not be revoked without the consent of the Commissioner or his delegate. The Commissioner or his delegate will consider allowing a revocation of an election if the taxpayer can demonstrate significantly changed circumstances or such other circumstances that clearly demonstrate a substantial non-tax business reason for revoking the election.

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

(a) Scope and general principles. Paragraph (b) of this section provides rules for attributing assets and liabilities, and items of income, gain, deduction, and loss, to an eligible QBU. Assets and liabilities are attributed to a section 987 QBU for purposes of section 987. Items of income, gain, deduction, and loss are attributed to a section 987

QBU for purposes of computing the section 987 taxable income of the section 987 QBU and of its owner. Paragraph (c) of this section defines a transfer to or from a section 987 QBU. Paragraph (d) of this section provides translation rules for transfers to a section 987 QBU.

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

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

(i) Stock of a corporation (whether domestic or foreign), other than stock of a corporation reflected on the books and records (within the meaning of paragraph (b)(1) of this section) of an eligible QBU if the owner of the eligible QBU owns less than 10

percent of the total value of all classes of stock of such corporation. For this purpose, section 318(a) applies in determining ownership, except that in applying section 318(a)(2)(C), the phrase “10 percent” is used instead of the phrase “50 percent.”

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

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

(iv) Income, gain, deduction, or loss arising from the items described in paragraphs (b)(2)(i) through (iii) of this section. For example, a section 951 inclusion with respect to stock of a foreign corporation described in paragraph (b)(2)(i) of this section shall not be considered to be on the books and records of an eligible QBU.

(3) Adjustments to items reflected on the books and records--(i) General rule. 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 Federal income tax under, or through the use of, section 987, the item must be allocated between or among the eligible QBU, the owner of such eligible QBU, and any other persons, entities (including DEs), or other QBUs within the meaning of §1.989(a)-1(b) (including eligible QBUs) in a manner that reflects the substance of the transaction. For purposes of this paragraph (b)(3)(i), relevant factors for determining whether such Federal income tax avoidance is a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU shall include, but are not limited to, the factors set forth in paragraphs (b)(3)(ii) and (iii) of this section. The presence or absence of any factor or factors is not determinative. Moreover, the weight given to any factor (whether or not set forth in paragraphs (b)(3)(ii) and (iii) of this section) depends on the particular case.

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

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

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

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

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

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

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

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

(iii) Factors indicating tax avoidance. For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987 include:

(A) The presence or absence of an item on the books and records that is the result of one or more transactions that are transitory, for example, due to a circular flow of cash or other property;

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

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

(D) The absence of any or all of the factors listed in paragraph (b)(3)(ii) of this section.

(4) Assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU. Neither a section 987 aggregate partnership nor a DE is an eligible QBU and, thus, neither entity can be a section 987 QBU. See §1.987-1(b)(2) and (3). As a result, a section 987 aggregate partnership or DE may own assets and liabilities that are not attributed to an eligible QBU as provided under this paragraph (b) and, therefore, are not subject to section 987. For the foreign currency treatment of such assets or liabilities, see §1.988-1(a)(4).

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

(2) Disregarded transactions--(i) General rule. An asset or liability shall be treated as transferred to a section 987 QBU from its owner (whether direct owner or

indirect owner, as defined in §1.987-1(b)(4)) if, as a result of a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section), such asset or liability is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section. Similarly, an asset or liability shall be treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, such asset or liability is no longer reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section.

(ii) Definition of a disregarded transaction. For purposes of this section, a disregarded transaction means a transaction that is not regarded for Federal income tax purposes (for example, any transaction between separate section 987 QBUs of the same owner). For purposes of this paragraph (c), a disregarded transaction shall be treated as including the recording of an asset or liability on the books and records of an eligible QBU (as defined in §1.987-1(b)(3)) of an owner, if the recording is the result of such asset or liability being removed from the books and records of a separate eligible QBU of the same owner, whether such separate eligible QBU is owned directly or is owned indirectly through the same entity (including through a DE or a section 987 aggregate partnership). Additionally, if an asset or liability that is attributable to a section 987 QBU within the meaning of paragraph (b) of this section is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is not attributable to the section 987 QBU immediately after the sale or exchange, the sold or exchanged asset or liability that was attributable to the section 987 QBU immediately before the transaction shall be treated as transferred from the section 987 QBU to its direct or indirect owner in a disregarded transaction immediately before the sale or exchange for purposes of section 987

(including for purposes of recognizing section 987 gain or loss under §1.987-5) and subsequently sold or exchanged by the owner. The preceding sentence shall not apply with respect to an acquisition or disposition of an interest in a section 987 aggregate partnership or in a DE, as described in paragraph (c)(5) of this section.

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

(3) Transfers of assets to and from section 987 QBUs owned through section 987 aggregate partnerships--(i) Contributions to section 987 aggregate partnerships. Solely for purposes of section 987, an asset shall be treated as transferred by an indirect owner (as defined in §1.987-1(b)(4)(ii)) to a section 987 QBU of a partner (as defined in §1.987-1(b)(5)(ii)) to the extent the indirect owner contributes the asset to the section 987 aggregate partnership that carries on the activities of the section 987 QBU, provided that, immediately prior to the contribution, the asset is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section and the asset is reflected on the books and records of the section 987 QBU immediately following such contribution. For purposes of this paragraph (c)(3)(i), deemed contributions of money described under section 752 shall be disregarded. See paragraph (c)(4)(ii) of this section for rules governing the assumption by a partner of liabilities of a section 987 aggregate partnership.

(ii) Distributions from section 987 aggregate partnerships. Solely for purposes of section 987, an asset shall be treated as transferred from a section 987 QBU of a partner to its indirect owner to the extent the section 987 aggregate partnership that

carries on the activities of the section 987 QBU distributes the asset to the indirect owner, provided that, immediately prior to such distribution, the asset is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the asset is not reflected on the books and records of the section 987 QBU immediately after such distribution. For purposes of this paragraph (c)(3)(ii), deemed distributions of money described under section 752 shall be disregarded. See paragraph (c)(4)(i) of this section for rules governing the assumption by a section 987 aggregate partnership of liabilities of a partner.

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

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

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

(6) Changes in form of ownership. For purposes of this paragraph (c), mere changes in the form of ownership of an eligible QBU shall not result in a transfer to or from a section 987 QBU. Instead, the determination of whether a transfer has occurred in such case shall be made under paragraph (c)(5) of this section. For example, a transaction that causes a direct owner of an eligible QBU to become an indirect owner of the eligible QBU shall not, except to the extent provided in paragraph (c)(5) of this section, result in a transfer to or from a section 987 QBU. See, for example, Rev. Rul. 99-5 (1999-1 CB 434), Rev. Rul. 99-6 (1999-1 CB 432), §601.601(d)(2) of this chapter, and section 708 and the applicable regulations.

(7) Application of general tax law principles. General tax law principles, including the circular cash flow, step-transaction, economic substance, and substance-over-form doctrines, apply for purposes of determining whether there is a transfer of an asset or liability under this paragraph (c), including a transfer of an asset or liability pursuant to a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section).

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

(9) [Reserved].

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

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

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

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

Example 2. Transfer to a directly owned section 987 QBU. (i) Facts. X owns Business A and Business B, both of which are section 987 QBUs of X. X owns equipment that is used in Business A and is reflected on the books and records of Business A. Because Business A has excess manufacturing capacity and X intends to expand the manufacturing capacity of Business B, the equipment formerly used in

Business A is transferred to Business B for use by Business B. As a result of the transfer, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B.

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

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

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

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

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

Example 4. Sale of property by a section 987 QBU to a corporation that is a member of the consolidated group. (i) Facts. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y file a consolidated return. Business A sells property to Y for €100.

(ii) Analysis. The sale of property by Business A to Y is not considered a transfer of property to X (and a corresponding transfer from X to Y) under paragraph (c) of this section because the transaction is regarded for Federal income tax purposes. Rather, for purposes of section 987, the transaction is considered to occur between Business A and Y.

Example 5. Transactions of a section 987 QBU owned through an aggregate partnership. (i) Facts. (A) X owns all of the stock of Y and a 50 percent interest in the capital and profits of P, a partnership. Y owns the other 50 percent interest in P. P owns 100 percent of the interests in DE1 and DE2. DE1 owns Business A and DE2 owns Business B.

(B) In connection with Business A, DE1 licenses intangible property to both DE2 and X. X enters into the license agreement in a transaction other than in its capacity as a partner of P and, therefore, the license is considered as occurring between P and one who is not a partner within the meaning of section 707(a). X uses the intangible property in its own trade or business in the U.S. DE2 uses the intangible property in Business B. Pursuant to the license agreement, X and DE2 pay a €30 and a €50 royalty, respectively, to DE1.

(ii) Analysis. (A) Under §1.987-1(b)(5)(i), P is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. X and Y each have a 50 percent allocable share of the assets and liabilities of Business A and Business B, as determined under §1.987-7. Under §1.987-1(b)(5)(ii), the assets and liabilities of Business A allocated to X are a section 987 QBU of X, and the assets and liabilities of Business A allocated to Y are a section 987 QBU of Y. Likewise, the assets and liabilities of Business B allocated to X are a section 987 QBU of X, and the assets and liabilities of Business B allocated to Y are a section 987 QBU of Y.

(B) The license from DE1 to DE2 is not regarded for Federal income tax purposes (because it is an interbranch agreement) and, as a result, royalty payments under the license are disregarded transactions. Thus, pursuant to paragraph (c)(2)(iii) of this section, DE1's receipt of the royalty pursuant to the license agreement does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under §1.987-3. However, the €50 that is paid from DE2 to DE1 pursuant to the license agreement must be taken into account under paragraph (c) of this section. Accordingly, €50 ceases to be reflected on the books and records of Business B and becomes reflected on the books and records of Business A. As a result, a 50 percent allocable share of the €50 royalty payment (€25) is treated as transferred from each of the Business B section 987 QBUs of X and Y, to X and Y, respectively. And subsequently, X and Y are treated as transferring their respective receipts of €25 to their respective Business A section 987 QBUs. These transfers are taken into account in determining the amount of any remittance to either of X or Y for the taxable year under §1.987-5(c).

(C) The €30 royalty payment from X to DE1 is regarded for Federal income tax purposes (because it is a payment from a partnership to a separate entity). Accordingly, the royalty payment is not a disregarded transaction for purposes of this paragraph (c) and is therefore not treated as a transfer of an asset from an owner to a section 987 QBU. As a result, the payment is not taken into account in determining the amount of any remittance for the taxable year under §1.987-5(c). Instead, the payment gives rise to an item of income and deduction that must be taken into account in computing section 987 taxable income or loss of Business A pursuant to §1.987-3.

Example 6. Acquisition of an interest in a partnership. (i) Facts. (A) X owns all of the stock of Z, a domestic corporation with the dollar as its functional currency. X also owns all of the stock of Y and a 50 percent interest in the capital and profits of P, a partnership. Y owns the other 50 percent interest in P. P owns Business A, and P owns no other assets or liabilities other than those of Business A.

(B) Z contributes cash to P in exchange for a 20 percent interest in the capital and profits of P. The cash Z contributes to P is used in Business A and is reflected on Business A's books and records.

(ii) Analysis. (A) Under §1.987-1(b)(5)(i), P is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Prior to the contribution to P by Z, X and Y each have a 50 percent allocable share of the assets and liabilities of Business A, as determined under §1.987-7. Under §1.987-1(b)(5)(ii), the assets and liabilities of Business A allocated to

X are a section 987 QBU of X, and the assets and liabilities of Business A allocated to Y are a section 987 QBU of Y.

(B) Following Z's acquisition of a 20 percent interest in P, P remains a section 987 aggregate partnership because X, Y and Z own all the interests in partnership capital and profits; X, Y, and Z are related within the meaning of section 267(b); and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Z acquires a 20 percent allocable share of the assets and liabilities of Business A, as determined under §1.987-7. Under §1.987-1(b)(5)(ii), the assets and liabilities of Business A allocated to Z are a section 987 QBU of Z (because Z becomes an indirect owner of Business A and Z and Business A have different functional currencies).

(C) As a result of Z's contribution of cash to Business A, through its contribution to P, each of X, Y, and Z are allocated a share of that Business A asset. Accordingly, under §1.987-2(c)(5), Z is treated as contributing its allocable share of the cash to its Business A section 987 QBU. In addition, Z is treated as transferring X's and Y's respective allocable shares of the cash to X and Y, and X and Y are subsequently treated as transferring that cash to their respective Business A section 987 QBUs.

(D) In addition, as a result of Z's acquisition of its interest in P and Z's consequent acquisition of a Business A section 987 QBU, Z's allocable portion of the assets and liabilities of Business A (other than the cash) cease being reflected on the books and records of the respective Business A section 987 QBUs of each of X and Y. Those allocable portions of assets and liabilities from the Business A section 987 QBUs of X and Y are treated as if they are transferred from such section 987 QBUs to their respective owners, X and Y. These assets and liabilities are consequently recorded on the books and records of Z's Business A section 987 QBU. Accordingly, X and Y are treated as transferring those assets and liabilities to Z, and Z is treated as contributing those assets and liabilities to its new Business A section 987 QBU.

Example 7. Acquisition of an interest in a partnership. (i) Facts. The facts are the same as in Example 6, except that the cash that Z contributes to P in exchange for a 20 percent interest in P is not used in Business A and is not reflected on Business A's books and records. Instead, the cash is reflected on P's books and records.

(ii) Analysis. (A) Following Z's acquisition of a 20 percent interest in P, P remains a section 987 aggregate partnership because X, Y and Z own all the interests in partnership capital and profits; X, Y, and Z are related within the meaning of section 267(b); and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Z acquires a 20 percent allocable share of the assets and liabilities of Business A, as determined under §1.987-7. Under §1.987-1(b)(5)(ii), the assets and liabilities of Business A allocated to Z are a section 987 QBU of Z (because Z becomes an indirect owner of Business A and Z and Business A have different functional currencies).

(B) As a result of Z's acquisition of its interest in P and Z's consequent acquisition of a Business A section 987 QBU, Z's allocable portion of the assets and liabilities of Business A cease being reflected on the books and records of the respective Business A section 987 QBUs of each of X and Y. Those allocable portions of assets and liabilities from the Business A section 987 QBUs of X and Y are treated as if they are transferred from such section 987 QBUs to their respective owners, X and Y. These assets and liabilities are consequently recorded on the books and records of Z's Business A section 987 QBU. Accordingly, X and Y are treated as transferring those assets and liabilities to Z, and Z is treated as contributing those assets and liabilities to its new Business A section 987 QBU.

Example 8. Conversion of a DE to a partnership through a sale of an interest. (i) Facts. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. Y acquires 50 percent of the DE1 interests from X for cash.

(ii) Analysis. (A) DE1 is converted to a partnership when Y purchases the 50 percent interest in DE1. For Federal income tax purposes, Y's purchase of 50 percent of X's interest in DE1 is treated as the direct purchase of 50 percent of the assets of Business A because DE1 is disregarded and Business A is treated as held directly by X. Immediately after the sale of 50 percent of Business A to Y, X and Y are treated as contributing their respective interests in the assets of Business A to a partnership. See Rev. Rul. 99-5 (1999-1 CB 434) (situation 1) and §601.601(d)(2) of this chapter.

(B) For purposes of this paragraph (c), these deemed transactions are disregarded transactions. Under §1.987-1(b)(5)(i), the newly formed partnership is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Because Y is a partner in a section 987 aggregate partnership that owns Business A and because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU of Y.

(C) As a result of the conversion of DE1 to a partnership, Y acquires an allocable share of 50 percent of the assets and liabilities of Business A, as determined under §1.987-7. Accordingly, 50 percent of the assets and liabilities of Business A cease being reflected on the books and records of X's section 987 QBU. Under §1.987-2(b)(5), these amounts are treated as if they are transferred from X's section 987 QBU to X, and X is treated as transferring these assets and liabilities to Y. Accordingly, the assets and liabilities of Business A allocated to Y are treated as transferred by Y to Y's newly formed Business A section 987 QBU.

Example 9. Conversion of a DE to a partnership through a contribution. (i)

Facts. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. Y contributes property (that is not then attributed to a section 987 QBU of Y) to DE1 in exchange for an interest in DE1. The property transferred by Y to DE1 is used in Business A and is reflected on the books and records of Business A.

(ii) Analysis. (A) DE1 is converted to a partnership when Y contributes property to DE1 in exchange for a 50 percent interest in DE1. For Federal income tax purposes, Y's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. X is treated as contributing all of Business A to the partnership in exchange for a partnership interest. See Rev. Rul. 99-5 (situation 2), (1999-1 CB 434) and §601.601(d)(2) of this chapter.

(B) For purposes of this paragraph (c), these deemed transactions are disregarded transactions. Under §1.987-1(b)(5)(i), the newly formed partnership is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Because Y is a partner in a section 987 aggregate partnership that owns Business A and because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU of Y.

(C) As a result of the conversion of DE1 to a partnership, Y acquires an allocable share of 50 percent of the assets and liabilities of Business A, as determined under §1.987-7. Accordingly, under §1.987-2(c)(5), Y is treated as contributing its allocable share of its contributed property to its Business A section 987 QBU. In addition, Y is treated as transferring X's allocable share of the contributed property to X, and X is subsequently treated as transferring that property to its Business A section 987 QBUs. In addition, Y's allocable share of the original (pre-conversion) assets and liabilities of Business A cease being reflected on the books and records of X's section 987 QBU. Under §1.987-2(b)(5), these amounts are treated as if they are transferred from X's section 987 QBU to X, and X is treated as transferring these assets and liabilities to Y. Y is subsequently treated as transferring these assets and liabilities to Y's Business A section 987 QBU.

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

(ii) Analysis. Pursuant to paragraph (b)(2) of this section, the Z stock received in exchange for 50 percent of Business A's assets and liabilities is not reflected on the books and records of, and therefore is not attributable to, Business A for purposes of

section 987 immediately after the exchange. As a result, pursuant to paragraph (c)(2)(i) and (ii) of this section, 50 percent of the assets and liabilities of Business A are treated as transferred from Business A to X in a disregarded transaction immediately before the exchange. The result would be the same even if X and Z filed a consolidated return.

Example 11. Circular transfers. (i) Facts. X owns Business A. On December 30, 2021, Business A purports to transfer €100 to X. On January 2, 2022, X purports to transfer €50 to Business A. On January 4, 2022, X purports to transfer another €50 to Business A. As of the end of 2021, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

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

Example 12. Transfers without substance. (i) Facts. X owns Business A and Business B. On January 1, 2021, Business A purports to transfer €100 to X. On January 4, 2021, X purports to transfer €100 to Business B. The account in which Business B deposited the €100 is used to pay the operating expenses and other costs of Business A. As of the end of 2021, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(ii) Analysis. Because Business A continues to have use of the transferred property, the IRS may disregard the €100 purported transfer from Business A to X for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

Example 13. Offsetting positions in section 987 QBUs. (i) Facts. X owns Business A and Business B. Each of Business A and Business B has the euro as its functional currency. X has not made a grouping election under §1.987-1(b)(2)(ii). On January 1, 2021, X borrows €1,000 from a third party lender, records the liability with respect to the borrowing on the books and records of Business A, and records the borrowed €1,000 on the books and records of Business B. On December 31, 2022, when Business A has \$100 of net unrecognized section 987 loss and Business B has \$100 of net unrecognized section 987 gain resulting from the change in exchange rates with respect to the liability and the €1,000, X terminates the Business A section 987 QBU.

(ii) Analysis. Because Business A and Business B have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine if a principal purpose of recording the euro-denominated liability on the books and records of Business A and the borrowed euros on the books and records of Business B was the avoidance of tax under section 987. If such a principal purpose is present, the IRS may reallocate the items (that is, the euros and the euro-denominated liability) between Business A, Business B, and X, under paragraph (c)(7) of this section to reflect the substance of the transaction.

Example 14. Offsetting positions with respect to a section 987 QBU and a section 988 transaction. (i) Facts. X owns all of the interests in DE1, and DE1 owns Business A. On January 1, 2021, X borrows €1,000 from a third party lender and records the liability with respect to the borrowing on its books and records. X contributes the €1,000 loan proceeds to DE1 and the €1,000 are reflected on the books and records of Business A. On December 31, 2022, when Business A has \$100 of net unrecognized section 987 loss resulting from the change in exchange rates with respect to the €1,000 received from the borrowing, and when the euro-denominated borrowing, if repaid, would result in \$100 of gain under section 988, X terminates the Business A section 987 QBU.

(ii) Analysis. Because X and Business A have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the borrowed euros on the books and records of Business A, or not recording the corresponding euro-denominated liability on the books and records of Business A, was the avoidance of tax under section 987. If such a principal purpose is present, the Commissioner may reallocate the items (that is, the euros and the euro-denominated liability) between Business A and X under paragraph (c)(7) of this section to reflect the substance of the transaction.

Example 15. Offsetting positions with respect to a section 987 QBU and a section 988 transaction. (i) Facts. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y file a consolidated return. On January 1, 2021, DE1 lends €1,000 to Y. X records the receivable with respect to the loan on Business A's books and records. On December 31, 2022, when Business A has \$100 of net unrecognized section 987 gain resulting from the loan, Y repays the €1,000 liability. The repayment of the euro-denominated borrowing results in \$100 of loss to Y under section 988. X claims a \$100 loss on its consolidated return under section 988. Business A does not make any remittances to X in 2022, so the offsetting gain with respect to the loan receivable has not been recognized by X.

(ii) Analysis. Y, a related party to X, and Business A have offsetting positions in the euro. The IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the euro-denominated receivable

on the books and records of Business A, rather than on the books and records of X, was to avoid tax through the use of section 987. If such a principal purpose is present, the IRS may reallocate the euro-denominated receivable between Business A and X under paragraph (c)(7) of this section to reflect the substance of the transaction. Other provisions may also apply to defer or disallow the loss.

Example 16. Loan by section 987 QBU followed by immediate distribution to owner. (i) Facts. X owns all of the interests in DE1. DE1 owns Business A. On January 1, 2021, Business A borrows €1,000 from a bank. On January 2, 2021, Business A distributes the €1,000 it received from the bank to X. There are no other transfers between X and Business A during the year. At the end of the year, X has net unrecognized section 987 loss with respect to Business A such that a remittance would result in the recognition of foreign currency loss under section 987.

(ii) Analysis. Because the proceeds from the loan to Business A are immediately transferred to X and the distribution from Business A to X could result in the recognition of section 987 loss, the IRS may scrutinize the recording of the loan on the books of Business A and move the loan onto the books of X, resulting in the transfer not being taken into account for purposes of section 987 under paragraph (b)(3) of this section.

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

(ii) Analysis. Under general tax law principles as provided in paragraph (c)(7) of this section, on July 1, 2021, Business A is treated for purposes of section 987 as making a transfer of €20 to X, and X is treated as making a €20 interest payment to the bank.

(d) Translation of items transferred to a section 987 QBU—(1) Marked items.

The adjusted basis of a marked asset, or the amount of a marked liability, transferred to a section 987 QBU shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in §1.987-1(c)(1)) applicable to the date of transfer. If the asset or liability transferred is denominated in (or determined by reference to) the functional currency of the section 987 QBU (for example, cash or a note denominated in

the functional currency of the section 987 QBU), no translation is required. See §1.988-1(a)(10)(ii) for special rules regarding intra-taxpayer transfers.

(2) Historic items. The adjusted basis of a historic asset, or the amount of a historic liability, transferred to a section 987 QBU shall be translated into the section 987 QBU's functional currency at the rate provided in §1.987-1(c)(3).

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

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

(b) Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency--(1) In general. Except as otherwise provided in this section, a section 987 QBU shall determine each item of income, gain, deduction, or loss of such section 987 QBU in its functional currency under Federal income tax principles.

(2) Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency--(i) In general. Except as otherwise provided in paragraphs (b)(2)(ii) and (b)(4) of this section, an item of income, gain, deduction, or loss that is

denominated in (or determined by reference to) a nonfunctional currency (including the functional currency of the owner) shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in §1.987-1(c)(1)) on the date such item is properly taken into account, subject to the limitation under §1.987-1(c)(1)(ii)(B) regarding the use of a spot rate convention. Examples 1, 2 and 6 of paragraph (e) of this section illustrate the application of this paragraph (b)(2)(i).

(ii) [Reserved].

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

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

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

(iv) Translation of items into the owner's functional currency. To the extent the items referred to in paragraph (b)(3)(iii) of this section are allocated to a partner, the

partner shall adjust the items to conform to Federal income tax principles and translate the items into the partner's functional currency as provided in paragraph (c) of this section.

(4) [Reserved].

(c) Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency--(1) In general. Except as otherwise provided in this section, the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss attributable to a section 987 QBU into the owner's functional currency, if necessary, shall be the yearly average exchange rate (as defined in §1.987-1(c)(2)) for the taxable year. However, an owner of a section 987 QBU that has elected under §1.987-1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates must use the spot rate (as defined in §1.987-1(c)(1)) for the date each item is properly taken into account.

(2) Exceptions--(i) Recovery of basis with respect to historic assets. Except as otherwise provided in this section, the exchange rate to be used by the owner in translating any recovery of basis (whether through a sale or exchange; deemed sale or exchange; cost recovery deduction such as depreciation, depletion or amortization; or otherwise) with respect to a historic asset (as defined in §1.987-1(e)) shall be the historic rate as determined under §1.987-1(c)(3) for the property to which such recovery of basis is attributable.

(ii) [Reserved].

(iii) Gain or loss on the sale, exchange or other disposition of an interest in a section 987 aggregate partnership. [Reserved].

(iv) Cost of goods sold computation.--(A) General rule—simplified inventory method. Cost of goods sold (COGS) for a taxable year shall be translated into the functional currency of the owner at the yearly average exchange rate (as defined in §1.987-1(c)(2)) for the taxable year and adjusted as provided in paragraph (c)(3) of this section.

(B) Election to use the historic inventory method. In lieu of using the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section, the owner of a section 987 QBU may elect under this paragraph (c)(2)(iv)(B) to translate inventoriable costs (including current-year inventoriable costs and costs that were capitalized into inventory in prior years) that are included in COGS at the historic rate as determined under §1.987-1(c)(3) for each such cost. As described in §1.987-1(c)(1)(iii), a taxpayer that elects to use spot rates in lieu of yearly average exchange rates as provided in that section will be deemed to have made the election described in this paragraph (c)(2)(iv)(B).

(3) Adjustments to COGS required under the simplified inventory method--(i) In general. An owner of a section 987 QBU that uses the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section must make the adjustment described in paragraph (c)(3)(ii) of this section. In addition, the owner must make the adjustment described in paragraph (c)(3)(iii) of this section with respect to any inventory for which the section 987 QBU does not use the LIFO inventory method (as described in section 472) and must make the adjustment described in paragraph (c)(3)(iv) of this section with respect to any inventory for which the section 987 QBU uses the LIFO inventory method. An owner of a section 987 QBU that uses the simplified inventory method must make all of the applicable adjustments described in paragraphs (c)(3)(ii) through

(iv) with respect to the section 987 QBU even in taxable years in which the amount of COGS is zero.

(ii) Adjustment for cost recovery deductions included in inventoriable costs. The translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) to reflect the difference between the historic rates appropriate for translating cost recovery deductions attributable to other historic assets and the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section, to the extent any such cost recovery deductions are included in inventoriable costs for the taxable year. The adjustment shall be included as an adjustment to translated COGS computed under paragraph (c)(2)(iv)(A) of this section in full in the year to which the adjustment relates and shall not be allocated between COGS and ending inventory. The adjustment for each cost recovery deduction shall be computed as the product of:

(A) The cost recovery deduction, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate specified in paragraph (c)(2)(i) of this section for translating the cost recovery deduction (that is, the historic rate for the property to which such deduction is attributable) less the exchange rate used to translate COGS under the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iii) Adjustment to beginning inventory for non-LIFO inventory. In the case of inventory with respect to which a section 987 QBU does not use the LIFO inventory method (non-LIFO inventory), the translated COGS amount computed under paragraph

(c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The ending non-LIFO inventory included on the closing balance sheet for the preceding year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§1.987-4(e)(2)(ii) and 1.987-1(c)(3)(i)(C) that is used for translating ending inventory on the closing balance sheet for the preceding year (that is, the yearly average exchange rate for the preceding year) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iv) Adjustment for year of LIFO liquidation. In the case of inventory with respect to which a section 987 QBU uses the LIFO inventory method, for each LIFO layer liquidated in whole or in part during the taxable year, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The amount of the LIFO layer liquidated during the taxable year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§1.987-4(e)(2)(ii) and 1.987-1(c)(3)(i)(C) that is used for translating such LIFO layer (that is, the yearly average exchange rate for the year such LIFO layer arose) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(d) [Reserved].

(e) Examples. The following examples illustrate the application of this section.

For purposes of the examples, U.S. Corp is a domestic corporation that uses the

calendar year as its taxable year and has the U.S. dollar as its functional currency. Except as otherwise indicated, U.S. Corp is the owner of Business A, a section 987 QBU with the euro as its functional currency, and elects under paragraph (c)(2)(iv)(B) of this section to use the historic inventory method with respect to Business A but does not make any other elections under section 987. However, where it is specified that U.S. Corp elects to use spot rates in lieu of yearly average exchange rates under §1.987-1(c)(1)(iii), U.S. Corp also elects under §1.987-1(c)(1)(ii) to use a spot rate convention. Under this convention, sales booked during a particular month are translated at the average of the spot rates on the first and last day of the preceding month (the “convention rate”). Exchange rates used in these examples are selected for the purpose of illustrating the principles of this section. No inference (for example, whether a currency is hyperinflationary or not) is intended by their use. See §1.987-4(g) for an illustration of the simplified inventory method described in paragraphs (c)(2)(iv)(A) and (c)(3) of this section.

Example 1. Business A properly accrues £100 of income from the provision of services. Under paragraph (b)(2)(i) of this section, the £100 is translated into €90 at the spot rate (as defined in §1.987-1(c)(1)) on the date of accrual, without the use of a spot rate convention. In determining U.S. Corp’s taxable income, the €90 of income is translated into dollars at the rate provided in paragraph (c)(1) of this section.

Example 2. Business A sells a historic asset consisting of non-inventory property for £100. Under paragraph (b)(2)(i) of this section, the £100 amount realized is translated into €85 at the spot rate (as defined in §1.987-1(c)(1)) on the sale date without the use of a spot rate convention. In determining U.S. Corp’s taxable income, the €85 is translated into dollars at the rate provided in paragraph (c)(1) of this section. The euro basis of the property is translated into dollars at the rate provided in paragraph (c)(2)(i) of this section (that is, the historic rate as determined under §1.987-1(c)(3)).

Example 3. (i) Business A uses a first-in, first-out (FIFO) method of accounting for inventory. Business A sells 1,200 units of inventory in 2021 for €3 per unit. Business A’s gross sales are translated under paragraph (c)(1) of this section at the

yearly average exchange rate for the year of the sale. The yearly average exchange rate is €1 = \$1.02 for 2020 and €1 = \$1.05 for 2021. Thus, Business A's dollar gross sales will be computed as follows:

### Gross Sales (2021)

<u>Month</u>	<u># of units</u>	<u>Amount in €</u>	<u>€/ \$ yearly average rate</u>	<u>Amount in \$</u>
Jan	100	€300	€1 = \$1.05	\$315.00
Feb	200	600	€1 = \$1.05	630.00
March	0	0	€1 = \$1.05	0
April	200	600	€1 = \$1.05	630.00
May	100	300	€1 = \$1.05	315.00
June	0	0	€1 = \$1.05	0
July	100	300	€1 = \$1.05	315.00
Aug	100	300	€1 = \$1.05	315.00
Sept	0	0	€1 = \$1.05	0
Oct	0	0	€1 = \$1.05	0
Nov	100	300	€1 = \$1.05	315.00
Dec	<u>300</u>	<u>900</u>	<u>€1 = \$1.05</u>	<u>945.00</u>
	1,200			\$3,780.00

(ii) The purchase price for each inventory unit was €1.50. Under §1.987-1(c)(3)(i) and paragraph (c)(2)(iv)(B) of this section, the basis of each item of inventory is translated into dollars at the yearly average exchange rate for the year the inventory was acquired.

### Opening Inventory and Purchases (2021)

<u>Month</u>	<u># of units</u>	<u>Amount in €</u>	<u>€/ \$ yearly average rate</u>	<u>Amount in \$</u>
<u>Opening inventory (purchased in Dec. 2020)</u>				
	100	€150	€1 = \$1.02	\$153.00
<u>Purchases in 2021</u>				
Jan	300	€450	€1 = \$1.05	\$472.50
Feb	0	0	€1 = \$1.05	0
March	0	0	€1 = \$1.05	0
April	300	450	€1 = \$1.05	472.50
May	0	0	€1 = \$1.05	0
June	0	0	€1 = \$1.05	0

July	300	450	€1 = \$1.05	472.50
Aug	0	0	€1 = \$1.05	0
Sept	0	0	€1 = \$1.05	0
Oct	0	0	€1 = \$1.05	0
Nov	300	450	€1 = \$1.05	472.50
Dec	<u>0</u>	0	€1 = \$1.05	<u>0</u>
	1,200			\$1,890.00

(iii) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in 2020 (\$153.00), the 300 units purchased in January 2021 (\$472.50), the 300 units purchased in April 2021 (\$472.50), the 300 units purchased in July 2021 (\$472.50), and 200 of the 300 units purchased in November 2021 (\$315.00). Accordingly, Business A's translated dollar COGS for 2021 is \$1,885.50. Business A's opening inventory for 2022 is 100 units of inventory with a translated dollar basis of \$157.50.

(iv) Accordingly, for purposes of section 987 Business A has gross income in dollars of \$1,894.50 (\$3,780.00 - \$1,885.50).

Example 4. (i) The facts are the same as in Example 3 except that U.S. Corp properly elects under paragraph §1.987-1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates. As a result, under paragraph (c)(3) of this section, U.S. Corp uses the convention rate to translate items of income, gain, deduction, or loss where such rate is appropriate. Thus, Business A's dollar gross sales will be computed as follows:

#### **Gross Sales (2021)**

<u>Sales</u>	<u># of units</u>	<u>Amount in €</u>	<u>€/ \$ convention rate</u>	<u>Amount in \$</u>
Jan	100	€300	€1 = \$1.00	\$300
Feb	200	600	€1 = \$1.05	630
March	0	0	€1 = \$1.03	0
April	200	600	€1 = \$1.02	612
May	100	300	€1 = \$1.04	312
June	0	0	€1 = \$1.05	0
July	100	300	€1 = \$1.06	318
Aug	100	300	€1 = \$1.05	315
Sept	0	0	€1 = \$1.06	0
Oct	0	0	€1 = \$1.07	0
Nov	100	300	€1 = \$1.08	324
Dec	<u>300</u>	900	€1 = \$1.08	<u>972</u>
	1,200			\$3,783

(ii) As in Example 3, the purchase price for each inventory unit was €1.50. Under §1.987-3(c)(2)(iv)(B), U.S. Corp uses the convention rate as the historic rate in determining COGS.

**Opening Inventory and Purchases (2021)**

<u>Month</u>	<u># of units</u>	<u>Amount in €</u>	<u>€/ \$ convention rate</u>	<u>Amount in \$</u>
<u>Opening inventory (purchased in December 2020)</u>				
	100	€150	€1 = \$1.00	\$150
<u>Purchases in 2021</u>				
Jan	300	€450	€1 = \$1.00	\$450
Feb	0	0	€1 = \$1.05	0
March	0	0	€1 = \$1.03	0
April	300	450	€1 = \$1.02	459
May	0	0	€1 = \$1.04	0
June	0	0	€1 = \$1.05	0
July	300	450	€1 = \$1.06	477
Aug	0	0	€1 = \$1.05	0
Sept	0	0	€1 = \$1.06	0
Oct	0	0	€1 = \$1.07	0
Nov	300	450	€1 = \$1.08	486
Dec	<u>0</u>	0	€1 = \$1.08	<u>0</u>
	1,200			\$1,872

(iii) As set forth in (i), Business A's gross sales are \$3783.

(iv) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in December 2020 (\$150), the 300 units purchased in January 2021 (\$450), the 300 units purchased in April 2021 (\$459), the 300 units purchased in July 2021 (\$477), and 200 of the 300 units purchased in November 2021 (\$324). Thus, Business A's COGS is \$1,860.

(v) Accordingly, Business A has gross income in dollars of \$1,923 (\$3,783 - \$1,860).

Example 5. The facts are the same as in Example 3 except that during 2021, Business A incurred €100 of depreciation expense with respect to a truck. No portion of the depreciation expense is an inventoriable cost. The truck was purchased on January 15, 2020. The yearly average exchange rate for 2020 was €1 = \$1.02. Under paragraph (c)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic rate. Under §1.987-1(c)(3)(i), the historic rate is the yearly average rate for 2020. Accordingly, U.S. Corp takes into account depreciation of \$102 with respect to Business A in 2021.

Example 6. The facts are the same as in Example 5 except that the €100 of depreciation expense incurred during 2021 with respect to the truck is an inventoriable cost. As a result, the depreciation expense is capitalized into the 1,200 units of inventory purchased by Business A in 2021. Of those 1,200 units, 1,100 units are sold during the year, and 100 units become ending inventory. The portion of depreciation expense capitalized into inventory that is sold during 2021 is reflected in Business A's euro COGS and is translated at the €1 = \$1.02 yearly average exchange rate for 2020, the year in which the truck was purchased. The portion of the depreciation expense capitalized into the 100 units of ending inventory is not taken into account in 2021 but, rather, will be taken into account in the year the ending inventory is sold, translated at the €1 = \$1.02 yearly average exchange rate for 2020.

Example 7. Business A purchased raw land on October 16, 2020, for €8,000 and sold the land on November 1, 2021, for €10,000. The yearly average exchange rate was €1 = \$1.02 for 2020 and €1 = \$1.05 for 2021. Under paragraph (c)(1) of this section, the amount realized is translated into dollars at the yearly average exchange rate for 2021 (€10,000 x \$1.05 = \$10,500). Under paragraph (c)(2)(i) of this section, the basis is determined at the historic rate for 2020, which is the yearly average rate under section §1.987-1(c)(3)(i) for such year (€8,000 x \$1.02 = \$8,160). Accordingly, the amount of gain reported by U.S. Corp on the sale of the land is \$2,340 (\$10,500 - \$8,160).

Example 8. The facts are the same as in Example 7 except that Business A properly elects under paragraph §1.987-1(c)(1)(iii) to use spot rates in lieu of yearly average rates. Accordingly, the amount realized will be translated at the convention rate for the date of sale, and the basis will be translated at the convention rate for the date of purchase. The convention rate is €1 = \$1.01 for October 2020 and is €1 = \$1.08 for November 2021. Under these facts, the amount realized, translated into dollars at the convention rate for November 2021, is \$10,800 (€10,000 x \$1.08), and the basis, translated at the convention rate for October 2020, is \$8,080 (€8,000 x \$1.01). The amount of gain reported by U.S. Corp on the sale of the land is \$2,720 (\$10,800 - \$8,080).

**§1.987-4 Determination of net unrecognized section 987 gain or loss of a section**

**987 QBU.**

(a) In general. The net unrecognized section 987 gain or loss of a section 987 QBU shall be determined by the owner annually as provided in paragraph (b) of this section in the owner's functional currency. Only assets and liabilities reflected on the books and records of the section 987 QBU under §1.987-2(b) shall be taken into account.

(b) Calculation of net unrecognized section 987 gain or loss. Net unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall equal the sum of:

(1) The section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years to which these regulations apply as determined in paragraph (c) of this section, and

(2) The section 987 QBU's unrecognized section 987 gain or loss for the current taxable year as determined in paragraph (d) of this section.

(c) Net accumulated unrecognized section 987 gain or loss for all prior taxable years--(1) In general. A section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is the aggregate of the amounts determined under §1.987-4(d) for all prior taxable years to which these regulations apply, reduced by the amounts taken into account under §1.987-5 upon remittances for all such prior taxable years.

(2) [Reserved].

(d) Calculation of unrecognized section 987 gain or loss for a taxable year. The unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall be determined under paragraphs (d)(1) through (8) of this section.

(1) Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year--(i) In general. The change in the owner functional currency net value of the section 987 QBU for the taxable year shall equal--

(A) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the taxable year; less

(B) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the preceding taxable year. This amount shall be zero in the case of the section 987 QBU's first taxable year.

(ii) Year section 987 QBU is terminated. If a section 987 QBU is terminated within the meaning of §1.987-8 during an owner's taxable year, the owner functional currency net value of the section 987 QBU as provided in paragraph (d)(1)(i)(A) of this section shall be determined on the date the section 987 QBU is terminated.

(2) Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner--(i) In general. The amount determined in paragraph (d)(1) of this section shall be increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section.

(ii) Assets transferred from the section 987 QBU to the owner during the taxable year. The assets transferred from the section 987 QBU to the owner for the taxable year shall equal the sum of:

(A) The amount of the section 987 QBU's functional currency and the aggregate adjusted basis of all marked assets (as defined in §1.987-1(d)), after taking into account §1.988-1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the spot rate (as defined in §1.987-1(c)(1)) applicable to the date of transfer; and

(B) The aggregate adjusted basis of all historic assets (as defined in §1.987-1(e)), after taking into account §1.988-1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the historic rate for each such asset (as defined in §1.987-1(c)(3)).

(3) Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU--(i) In general. The aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section shall be decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner as provided in paragraph (d)(3)(ii) of this section.

(ii) Total of all amounts transferred from the owner to the section 987 QBU during the taxable year. The total amount of assets transferred from the owner to the section 987 QBU for the taxable year shall equal the aggregate of:

(A) The total amount of functional currency of the owner transferred to the section 987 QBU during the taxable year; and

(B) The adjusted basis, determined in the functional currency of the owner, of any asset transferred to the section 987 QBU during the taxable year (after taking into account §1.988-1(a)(10)).

(4) Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner. The aggregate amount determined in paragraphs (d)(1) through (3) of this section shall be decreased by the aggregate amount of liabilities transferred from the section 987 QBU to the owner during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate (as defined in §1.987-1(c)(1)) applicable on the date of transfer.

(5) Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU. The aggregate amount determined in paragraphs (d)(1) through (4) of this section shall be increased by the aggregate amount of liabilities transferred by the owner to the section 987 QBU during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate (as defined in §1.987-1(c)(1)) applicable on the date of transfer.

(6) Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year. The aggregate amount determined in paragraphs (d)(1) through (5) of this section shall be decreased or increased by the section 987 taxable income or loss, respectively, computed under §1.987-3 for the taxable year.

(7) Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of

the section 987 QBU for the taxable year. The aggregate amount determined under paragraphs (d)(1) through (6) shall be increased by the amount of any expense or loss attributable to a section 987 QBU for the taxable year that is not deductible in computing the section 987 QBU's taxable income or loss for the year, including any foreign income taxes incurred by the section 987 QBU with respect to which the owner claims a credit (translated at the same rate at which such taxes were translated under section 986(a)).

(8) Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any tax-exempt income. The aggregate amount determined under paragraphs (d)(1) through (7) shall be decreased by the amount of any income or gain attributable to a section 987 QBU for the taxable year that is not included in computing the section 987 QBU's taxable income or loss for the year.

(e) Determination of the owner functional currency net value of a section 987 QBU--(1) In general. The owner functional currency net value of a section 987 QBU on the last day of a taxable year shall equal the aggregate amount of functional currency and the adjusted basis of each asset on the section 987 QBU's balance sheet on that day, less the aggregate amount of each liability on the section 987 QBU's balance sheet on that day, in each case translated into the owner's functional currency as provided in paragraph (e)(2) of this section. Such amount shall be determined by:

(i) Preparing a balance sheet for the relevant date from the section 987 QBU's books and records (within the meaning of §1.989(a)-1(d)), as recorded in the section 987 QBU's functional currency and showing all assets and liabilities reflected on such books and records as provided in §1.987-2(b);

(ii) Making adjustments necessary to conform the items reflected on the balance sheet described in paragraph (e)(1)(i) of this section to United States tax accounting principles; and

(iii) Translating the asset and liability amounts on the adjusted balance sheet described in paragraph (e)(1)(ii) of this section into the functional currency of the owner in accordance with paragraph (e)(2) of this section.

(2) Translation of balance sheet items into the owner's functional currency. The amount of the section 987 QBU's functional currency, the basis of an asset, or the amount of a liability shall be translated as follows:

(i) Marked item. A marked item (as defined in §1.987-1(d)) shall be translated into the owner's functional currency at the spot rate (as defined in §1.987-1(c)(1)) applicable to the last day of the relevant taxable year.

(ii) Historic item. A historic item (as defined in §1.987-1(e)) shall be translated into the owner's functional currency at the historic rate (as defined in §1.987-1(c)(3)).

(f) [Reserved].

(g) Examples. The following examples illustrate the provisions of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the dollar as its functional currency. Except as otherwise indicated, U.S. Corp elects under §1.987-3(c)(2)(iv)(B) to use the historic inventory method with respect to all of its section 987 QBUs but does not make other elections under section 987. Exchange rate and tax accounting (for example, depreciation rate) assumptions used in these examples are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use.

Additionally, the examples are not intended to demonstrate when activities constitute a

trade or business within the meaning of §1.989(a)-1(b)(2)(ii)(A) and §1.989(a)-1(c) and therefore whether a section 987 QBU is considered to exist.

Example 1. (i) On July 1, 2021, U.S. Corp establishes Japan Branch, a section 987 QBU of U.S. Corp that has the yen as its functional currency, and transfers to Japan Branch \$1,000 and raw land with a basis of \$500. Japan Branch immediately exchanges the \$1,000 for ¥100,000. On the same day, Japan Branch borrows ¥10,000. For the taxable year 2021, Japan Branch earns ¥2,000 per month (total of ¥12,000 for the six-month period from July 1, 2021, through December 31, 2021) for providing services and incurs ¥333.33 per month (total of ¥2,000 when rounded for the six-month period from July 1, 2021, through December 31, 2021) of related expenses. Assume that the spot rate on July 1, 2021, is \$1 = ¥100; the spot rate on December 31, 2021, is \$1 = ¥120; and the average rate for the period of July 1, 2021, to December 31, 2021, is \$1 = ¥110. Thus, the ¥12,000 of services revenue when properly translated under §1.987-3(c)(1) at the yearly average exchange rate equals \$109.09 ( $¥12,000 \times (\$1 / ¥110) = \$109.09$ ). The ¥2,000 of expenses translated at the same yearly average exchange rate equals \$18.18 ( $¥2,000 \times (\$1 / ¥110) = \$18.18$ ). Thus, Japan Branch's net income translated into dollars equals \$90.91 ( $\$109.09 - \$18.18 = \$90.91$ ).

(ii) Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for 2021. Because this is Japan Branch's first taxable year, the net unrecognized section 987 gain or loss (as defined under paragraph (b) of this section) is the branch's unrecognized section 987 gain or loss for 2021 as determined in paragraph (d) of this section. The calculation under paragraph (d) of this section is made as follows:

(iii) Step 1. Under paragraph (d)(1) of this section, U.S. Corp must determine the change in the owner functional currency net value (OFCNV) of Japan Branch for 2021 in dollars. The change in the OFCNV of Japan Branch for 2021 is equal to the OFCNV of Japan Branch determined in dollars on the last day of 2021, less the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year.

(A) The OFCNV of Japan Branch determined in dollars on the last day of the current taxable year is determined under paragraph (e) of this section as the sum of the basis of each asset on Japan Branch's balance sheet on December 31, 2021, less the sum of each liability on Japan Branch's balance sheet on that date, translated into dollars as provided in paragraph (e)(2) of this section.

(B) For this purpose, Japan Branch will show the following assets and liabilities on its balance sheet for December 31, 2021:

(1) ¥120,000;

(2) Raw land with a basis of ¥55,000 (\$500 translated under §1.987-2(d)(2) at the historic rate of \$1 = ¥110); and

(3) Liabilities of ¥10,000.

(C) Under paragraph (e)(2) of this section, U.S. Corp will translate these items as follows. The ¥120,000 is a marked asset and the ¥10,000 liability is a marked liability (as each is defined in §1.987-1(d)). These items are translated into dollars on December 31, 2021, using the spot rate on December 31, 2021, of \$1 = ¥120. The raw land is a historic asset (as defined in §1.987-1(e)) and is translated into dollars under paragraph (e)(2)(ii) of this section at the historic rate, which under §1.987-1(c)(3)(1)(A) is the yearly average exchange rate of \$1 = ¥110 applicable to the year the land was transferred to the QBU. Thus, the OFCNV of Japan Branch on December 31, 2021, in dollars is \$1,416.67 determined as follows:

<u>Assets</u>	<u>Amount in ¥</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Yen	¥120,000	\$1 = ¥120 (spot rate-12/31/21)	\$1,000.00
Land	55,000	\$1 = ¥110 (yearly average rate-2021)	<u>500.00</u>
Total assets			\$1,500.00
 <u>Liabilities</u>			
Bank Loan	¥10,000	\$1 = ¥120 (spot rate-12/31/21)	<u>\$83.33</u>
Total liabilities			\$83.33
2021 ending OFCNV			\$1,416.67

(D) Under paragraph (d)(1) of this section, the change in OFCNV of Japan Branch for 2021 is equal to the OFCNV of the branch determined in dollars on December 31, 2021, (\$1,416.67) less the OFCNV of the branch determined in dollars on the last day of the preceding taxable year. Because this is the first taxable year of Japan Branch, the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year is zero under paragraph (d)(1)(i)(B) of this section. Accordingly, the change in OFCNV of Japan Branch for 2021 is \$1,416.67.

(iv) Step 2. Under paragraph (d)(2) of this section, the aggregate amount determined in paragraph (d)(1) of this section (step 1) is increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section. Because no such amounts were transferred, there is no change in the \$1,416.67 determined in step 1.

(v) Step 3. Under paragraph (d)(3) of this section, the aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section (steps 1 and 2) is decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year as determined in paragraph (d)(3)(ii) of this section in dollars. On July 1, 2021, U.S. Corp transferred to Japan Branch \$1,000.00 (which Japan Branch immediately converted into ¥100,000) and raw land with a basis of \$500.00 (equal to ¥55,000, translated under §1.987-2(d)(2) at the historic rate of \$1 = ¥110). Thus, the \$1,416.67 determined under steps 1 and 2 is reduced by \$1,500.00, resulting in (\$83.33).

(vi) Steps 4 and 5. Because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year, the aggregate amount determined in paragraph (d)(3) of this section (Step 3) is not increased or decreased.

(vii) Step 6. Under paragraph (d)(6) of this section, the aggregate amount determined after applying paragraphs (d)(1) through (5) of this section (steps 1 through 5) is decreased by the section 987 taxable income of Japan Branch of \$90.91 from (\$83.33) to (\$174.24).

(viii) Steps 7 and 8. Paragraphs (d)(7) and (d)(8) do not apply because Japan Branch does not have any tax-exempt or nondeductible items. Accordingly, the unrecognized section 987 loss of Japan Branch for 2021 is (\$174.24), the amount determined after applying step 6.

Example 2. (i) U.S. Corp operates in the United Kingdom through U.K. Branch, a section 987 QBU of U.S. Corp that has the pound as its functional currency. U.S. Corp properly elects under §1.987-1(c)(1)(ii) for U.K. Branch to use a spot rate convention (when permitted). Under the chosen convention, the spot rate (the “convention rate”) for any transaction occurring during a month is the average of the pound spot rate and the 30-day forward rate for pounds on the next-to-last Thursday of the preceding month. The yearly average exchange rate was £1 = \$0.90 for 2020, £1 = \$1.00 for 2021, and £1 = \$1.10 for 2022. The closing balance sheet of U.K. Branch in 2021 reflected the following assets:

(A) £100;

(B) A sales office purchased in 2020 with an adjusted basis of £1,000;

(C) A delivery truck purchased in 2020 with an adjusted basis of £200;

(D) Inventory of 100 units purchased in 2021 with a basis of £100; and

(E) Stock in ABC Corporation purchased in 2021 with a basis of £150, representing less than 10 percent of the total voting power and value of all classes of stock of ABC Corporation.

The closing balance sheet of U.K. Branch for 2021 reflected one liability, £50 of long-term debt entered into in 2020 with F Bank, an unrelated bank.

The office, truck, stock, and inventory are historic assets (as defined in §1.987-1(e)). The £100 and long-term debt are marked items (as defined in §1.987-1(d)). Assume that U.S. Corp translated U.K. Branch's 2021 closing balance sheet as follows:

<u>Assets</u>	<u>Amount in £</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Pounds	£100.00	£1 = \$1.05 (convention rate-Dec. 2021)	\$105.00
Office	1,000.00	£1 = \$0.90 (historic rate-2020)	900.00
Truck	200.00	£1 = \$0.90 (historic rate-2020)	180.00
Stock	50.00	£1 = \$1.00 (historic rate-2021)	150.00
Inventory	100.00	£1 = \$1.00 (historic rate-2021)	100.00
Total assets			\$1435.00
<u>Liabilities</u>			
Bank Loan	£50.00	£1 = \$1.05 (convention rate-Dec. 2021)	<u>\$52.50</u>
Total liabilities			\$52.50
2021 ending OFCNV			\$1,382.50

(ii) U.K. Branch uses the first-in, first-out (FIFO) method of accounting for inventory. In 2022, U.K. Branch sold 100 units of inventory for a total of £300 and purchased another 100 units of inventory for £100. There is depreciation of £33 with respect to the office and £40 with respect to the truck, and U.K. Branch incurred £30 of business expenses during 2022. Neither the depreciation nor the business expenses are inventoriable costs. All items of income earned and expenses incurred during 2022 are received and paid, respectively, in pounds. Under §1.987-3, U.K. Branch's section 987 taxable income or loss is determined as follows:

<u>Item</u>	<u>Amount in £</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Gross receipts	£300.00	£1 = \$1.10 (yearly average rate-2022)	\$330.00
Less: COGS	(100.00)	£1 = \$1.00 (historic rate-2021)	<u>(100.00)</u>
Gross income			\$230.00
Dep: Office	(33.00)	£1 = \$0.90 (historic rate-2020)	(\$29.70)

Truck	(40.00)	£1 = \$0.90 (historic rate-2020)	(36.00)
Other expenses	(30.00)	£1 = \$1.10 (yearly average rate-2022)	<u>(33.00)</u>
Total expenses			(\$98.70)
Section 987 taxable income			\$131.30

Accordingly, U.K. Branch has \$131.30 of section 987 taxable income in 2022.

(iii) In December 2022, U.K. Branch transferred £30 to U.S. Corp, and U.S. Corp transferred a computer with a basis of \$10 to U.K. Branch. U.S. Corp's net accumulated unrecognized section 987 gain or loss for all prior taxable years as determined in paragraph (c) of this section is \$30.

(iv) The unrecognized section 987 gain or loss of U.K. Branch for 2022 is determined as follows:

(A) Step 1. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of U.K. Branch determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of U.K. Branch determined on the last day of 2021. The OFCNV of U.K. Branch on December 31, 2022, and the change in OFCNV for 2022, are determined as follows:

<u>Assets</u>	<u>Amount in £</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Pounds	£240.00	£1 = \$1.15 (convention rate-Dec. 2022)	\$276.00
Office	967.00	£1 = \$0.90 (historic rate-2020)	870.30
Truck	160.00	£1 = \$0.90 (historic rate-2020)	144.00
Inventory	100.00	£1 = \$1.10 (historic rate-2022)	110.00
Computer	9.09	£1 = \$1.10 (historic rate-2022)	10.00
Stock	150.00	£1 = \$1.00 (historic rate-2021)	150.00
Total assets			\$1,560.30
<u>Liabilities</u>			
Bank Loan	£50.00	£1 = \$1.15 (convention rate-Dec. 2022)	<u>\$57.50</u>
Total liabilities			\$57.50
2022 ending OFCNV			\$1,502.80
Less: 2021 ending OFCNV			<u>(1,382.50)</u>
Change in OFCNV			\$120.30

(B) Step 2. Under paragraph (d)(2) of this section, the aggregate amount determined in step 1 must be increased by the total amount of assets described in

paragraph (d)(2)(ii) of this section transferred from U.K. Branch to U.S. Corp during the taxable year, translated into U.S. Corp's functional currency as provided in paragraph (d)(2)(ii) of this section. The amount of assets transferred from U.K. Branch to U.S. Corp during 2022 is determined as follows:

<u>Asset</u>	<u>Amount in £</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
£30	£30.00	£1 = \$1.15 (convention rate-Dec. 2022)	\$34.50

(C) Step 3: Decrease the aggregate amount described in steps 1 and 2 by the owner's transfers to the section 987 QBU. Under paragraph (d)(3) of this section, the aggregate amount determined in steps 1 and 2 must be decreased by the total amount of all assets transferred from U.S. Corp to U.K. Branch during the taxable year as determined in paragraph (d)(3)(ii) of this section. The amount of assets transferred from U.S. Corp to U.K. Branch during 2022 is determined as follows:

<u>Asset</u>	<u>Amount in \$</u>
Computer	\$10.00

(D) Step 4. Under paragraph (d)(4) of this section, the aggregate amount determined in steps 1 through 3 must be decreased by the aggregate amount of liabilities transferred by U.K. Branch to U.S. Corp. Under these facts, such amount is \$0.

(E) Step 5. Under paragraph (d)(5) of this section, the aggregate amount determined in steps 1 through 4 must be increased by the aggregate amount of liabilities transferred by U.S. Corp to U.K. Branch. Under these facts, such amount is \$0.

(F) Step 6. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 is decreased or increased, respectively, by any section 987 taxable income or loss of U.K. Branch computed under §1.987-3 for the taxable year. The amount of U.K. Branch's taxable income, as determined above, is \$131.30.

(H) Steps 7 and 8: Paragraphs (d)(7) and (d)(8) do not apply because U.K. Branch does not have any tax-exempt income or nondeductible expense.

(v) Summary. Taking steps 1 through 8 into account, the amount of U.S. Corp's unrecognized section 987 gain or loss with respect to U.K. Branch in 2022 is computed as follows:

<u>Step</u>	<u>Amount in \$</u>	<u>Balance</u>
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1	+ \$120.30	\$120.30
2	+ 34.50	154.80
3	- 10.00	144.80
4	- 0	144.80
5	+ 0	144.80
6	- 131.30	13.50
7	+ 0	13.50
8	- 0	13.50

Thus, U.S. Corp's unrecognized section 987 gain for 2022 with respect to U.K. Branch is \$13.50. As of the end of 2022, before taking into account the recognition of any section 987 gain or loss under §1.987-5, U.S. Corp's net unrecognized section 987 gain is \$43.50 (that is, \$30.00 accumulated from prior years, plus \$13.50 in 2022).

**Example 3. (i) Background.** U.S. Corp is the owner of Business A, a section 987 QBU that has the euro as its functional currency. Business A uses the FIFO method to account for inventory and uses the simplified inventory method described in §1.987-3(c)(2)(iv)(A). On the last day of 2020, U.S. Corp begins Business A by contributing to Business A a building with a basis of \$780, a machine with a basis of \$300, and \$100. On January 1, 2021, Business A converts the \$100 into €100. The tax basis of the building and machine is translated into euros using the historic rate, which is the yearly average exchange rate for 2020, the year of the transfer. Accordingly, the building and the machine have a tax basis of €780 and €300, respectively, on December 31, 2020. The building and machine have annual depreciation of €20 and €30, respectively. Business A determines that 50 percent of the building depreciation should be allocated to the cost of goods manufactured (that is, treated as an inventoriable cost) and 50 percent should be allocated to selling, general and administrative (SG&A) expenses. The machine is used exclusively to manufacture inventory. Relevant exchange rates for purposes of this example are as follows:

<u>Year</u>	<u>Yearly Average Exchange Rate</u>	<u>December 31 Spot Rate</u>
2020	€1 = \$1.00	€1 = \$1.00
2021	€1 = \$1.50	€1 = \$2.00

2022

€1 = \$2.50

€1 = \$3.00

(ii) Operations in 2021. During 2021, Business A recognizes €140 of revenue from sales of finished goods. The related COGS is €70. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2021 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2021, shows no liabilities and the following assets: currency of €160, the building with an adjusted basis of €760, the machine with an adjusted basis of €270, and ending inventory with a FIFO cost basis of €40, comprising raw materials and finished goods.

(A) Determination of income. Under the simplified inventory method, Business A's income for 2021 is computed as follows:

<u>Item</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Sales revenue	€140	€1 = \$1.50 (yearly avg. rate-2021)	\$210
COGS before adjustments	70	€1 = \$1.50 (yearly avg. rate-2021)	\$105
Adjustment for cost recovery deductions (see calculation below)			(20)
Adjustment for beginning inventory (none)			<u>0</u>
Adjusted COGS			\$85
SG&A			
Depreciation on building (50%)	10	€1 = \$1.00 (historic rate-2020)	\$10
Salaries	10	€1 = \$1.50 (yearly avg. rate-2021)	<u>15</u>
Total SG&A			\$25
Section 987 net income (revenue less COGS and SG&A)			\$100

### COGS Adjustments

Adjustment for cost recovery deductions included in inventoriable costs

<u>Depreciation Amount</u>	<u>Historic Rate</u>	<u>2021 Yearly Avg. Rate</u>	<u>Difference in Translation Rates</u>	<u>Adjustment (Depreciation x Change in Rates)</u>
€10 (building)	1.00	1.50	(0.50)	(\$5)
€30 (machine)	1.00	1.50	(0.50)	<u>(\$15)</u>
Total adjustment for cost recovery deductions				(\$20)

(B) Determination of OFCNV for 2020 and 2021.

Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

<u>OFCNV--End of 2021</u>			
<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€160	€1 = \$2.00 (year-end spot rate-2021)	\$320
Building	760	€1 = \$1.00 (historic rate-2020)	760
Machine	270	€1 = \$1.00 (historic rate-2020)	270
Inventory	40	€1 = \$1.50 (yearly average rate-2021)	<u>60</u>
Total assets			\$1,410
 <u>Liabilities</u>			
Total liabilities			\$0
2021 ending OFCNV			\$1,410

<u>OFCNV--End of 2020</u>			
<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€100	€1 = \$1.00 (year-end spot rate-2020)	\$100
Building	780	€1 = \$1.00 (historic rate-2020)	780
Machine	300	€1 = \$1.00 (historic rate-2020)	<u>300</u>
Total assets			\$1,180
 <u>Liabilities</u>			
Total liabilities			\$0
2020 ending OFCNV			\$1,180

(C) Determination of net unrecognized section 987 gain or loss. The net unrecognized section 987 gain or loss of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(1) Step 1. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A

determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	\$1,410
Less: 2020 ending OFCNV	<u>(1,180)</u>
Change in OFCNV	\$230

(2) Step 6. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is \$100.

Change in OFCNV	\$230
Less: section 987 taxable income	<u>(100)</u>
Unrecognized section 987 gain	\$130
Plus: net accumulated unrecognized section 987 gain or loss from prior years	<u>0</u>
Net unrecognized section 987 gain	\$130

(iii) Operations in 2022. During 2022, Business A recognizes €180 of revenue from sales of finished goods. The related COGS is €96. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2022 include €30 of depreciation on the machine and €10 of depreciation on the building. Business A's balance sheet on December 31, 2022, shows no liabilities and the following assets: currency of €260, the building with an adjusted basis of €740, the machine with an adjusted basis of €240, and ending inventory with a FIFO cost basis of €54, comprising raw materials and finished goods.

(A) Determination of income. Under the simplified inventory method, Business A's income for 2022 is computed as follows:

<u>Item</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Sales revenue	€180	€1 = \$2.50 (yearly avg. rate-2022)	\$450
COGS before adjustments	96	€1 = \$2.50 (yearly avg. rate-2022)	\$240
Adjustment for cost recovery deductions (see calculation below)			(60)
Adjustment for beginning inventory (see calculation below)			<u>(40)</u>
Adjusted COGS			\$140

SG&A

Depreciation on building (50%)	10	€1 = \$1.00 (historic rate-2020)	\$10
Salaries	10	€1 = \$2.50 (yearly avg. rate-2022)	<u>25</u>
Total SG&A			\$35
Section 987 net income (revenue less COGS and SG&A)			\$275

### COGS Adjustments

Adjustment for cost recovery deductions

<u>Depreciation Amount</u>	<u>Historic Rate</u>	<u>2022 Yearly Avg. Rate</u>	<u>Difference in Translation Rates</u>	<u>Adjustment (Depreciation x Change in Rates)</u>
€10 (building)	1.00	2.50	(1.50)	(\$15)
€30 (machine)	1.00	2.50	(1.50)	<u>(\$45)</u>
Total adjustment for cost recovery deductions				(\$60)

Adjustment for beginning inventory

<u>Prior Year Ending Inventory</u>	<u>2021 Yearly Avg. Rate</u>	<u>2022 Yearly Avg. Rate</u>	<u>Difference in Translation Rates</u>	<u>Adjustment (Inventory x Change in Rates)</u>
€40	1.50	2.50	(1.00)	<u>(\$40)</u>
Total adjustment for beginning inventory				(\$40)

(B) Determination of OFCNV. Under the simplified inventory method, the OFCNV of Business A for 2022 is determined under paragraph (e) of this section as follows:

### OFCNV--End of 2022

<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€260	€1 = \$3.00 (year-end spot rate-2022)	\$780
Building	740	€1 = \$1.00 (historic rate-2020)	740
Machine	240	€1 = \$1.00 (historic rate-2020)	240
Inventory	54	€1 = \$2.50 (yearly average rate-2022)	<u>135</u>
Total assets			\$1,895

## Liabilities

Total liabilities	\$0
2022 ending OFCNV	\$1,895

(C) Determination of net unrecognized section 987 gain or loss. The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(1) Step 1. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	\$1,895
Less: 2021 ending OFCNV	<u>(1,410)</u>
Change in OFCNV	\$485

(2) Step 6. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is \$275.

Change in OFCNV	\$485
Less: section 987 taxable income	<u>(275)</u>
Unrecognized section 987 gain 2022	\$210
Plus: net accumulated unrecognized section 987 gain from prior year	<u>130</u>
Net unrecognized section 987 gain	\$340

Example 4. (i) Background. The background facts about Business A are the same as in Example 3, except that Business A uses the dollar-value LIFO method to account for inventory.

(ii) Operations in 2021. The facts about Business A's operations in 2021 are the same as in Example 3.

(A) Determination of income. Under the simplified inventory method, Business A's income for 2021 is computed as follows:

<u>Item</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Sales revenue	€140	€1 = \$1.50 (yearly avg. rate-2021)	\$210
COGS before adjustments	70	€1 = \$1.50 (yearly avg. rate-2021)	\$105
Adjustment for cost recovery deductions (same as <u>Example 1</u> )			(20)
Adjustment for LIFO liquidation (none)			<u>0</u>
Adjusted COGS			\$85
SG&A			
Depreciation on building (50%)	10	€1 = \$1.00 (historic rate-2020)	\$10
Salaries	10	€1 = \$1.50 (yearly avg. rate-2021)	<u>15</u>
Total SG&A			\$25
Section 987 net income (revenue less COGS and SG&A)			\$100

(B) Determination of OFCNV for 2020 and 2021. Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV--End of 2021

<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€160	€1 = \$2.00 (year-end spot rate-2021)	\$320
Building	760	€1 = \$1.00 (historic rate-2020)	760
Machine	270	€1 = \$1.00 (historic rate-2020)	270
Inventory	40	€1 = \$1.50 (historic rate-2021)	<u>60</u>
Total assets			\$1,410
<u>Liabilities</u>			
Total liabilities			\$0
2021 ending OFCNV			\$1,410

OFCNV--End of 2020

<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€100	€1 = \$1.00 (year-end spot rate-2020)	\$100
Building	780	€1 = \$1.00 (historic rate-2020)	780
Machine	300	€1 = \$1.00 (historic rate-2020)	<u>300</u>

Total assets	\$1,180
<u>Liabilities</u>	
Total liabilities	\$0
2020 ending OFCNV	\$1,180

(C) Determination of net unrecognized section 987 gain or loss. The net unrecognized section 987 gain or loss of Business A for 2021 is determined under paragraph (d) of this section as follows (relevant steps only):

(1) Step 1. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	\$1,410
Less: 2020 ending OFCNV	<u>(1,180)</u>
Change in OFCNV	\$230

(2) Step 6. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is \$100.

Change in OFCNV	\$230
Less: section 987 taxable income	<u>(100)</u>
Unrecognized section 987 gain	\$130
Plus: Net accumulated unrecognized section 987 gain or loss from prior years	<u>0</u>
Net unrecognized section 987 gain	\$130

(iii) Operations in 2022. The facts about Business A's operations in 2022 are the same as in Example 3, except that due to Business A's dollar-value LIFO method of inventory accounting, Business A's balance sheet on December 31, 2022, reflects a 2021 layer of inventory with a LIFO cost basis of €40 and a 2022 layer of inventory with a LIFO cost basis of €10.80, and Business A's COGS is €99.20.

(A) Determination of income. Business A's income for 2022 is computed as follows:

<u>Item</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Sales revenue	€180	€1 = \$2.50 (yearly avg. rate-2022)	\$450
COGS before adjustments	99.20	€1 = \$2.50 (yearly avg. rate-2022)	\$248
Adjustment for cost recovery deductions (same as <u>Example 3</u> )			(60)
Adjustment for LIFO liquidation (none)			<u>0</u>
Adjusted COGS			\$188
SG&A			
Depreciation on building (50%)	10	€1 = \$1.00 (historic rate-2020)	\$10
Salaries	10	€1 = \$2.50 (yearly avg. rate-2022)	<u>25</u>
Total SG&A			\$35
Section 987 net income (revenue less COGS and SG&A)			\$227

OFCNV--End of 2022

<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€260.00	€1 = \$3.00 (year-end spot rate-2022)	\$780
Building	740.00	€1 = \$1.00 (historic rate-2020)	740
Machine	240.00	€1 = \$1.00 (historic rate-2020)	240
Inventory	10.80	€1 = \$2.50 (historic rate-2022)	27
	40.00	€1 = \$1.50 (historic rate-2021)	<u>60</u>
Total assets			\$1,847
<u>Liabilities</u>			
Total liabilities			\$0
2022 ending OFCNV			\$1,847

(B) Determination of net unrecognized section 987 gain or loss. The net unrecognized section 987 gain of Business A for 2022 is determined under paragraph (d) of this section as follows (relevant steps only):

(1) Step 1. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	\$1,847
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Less: 2021 ending OFCNV	(1,410)
Change in OFCNV	\$437

(2) Step 6--Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is \$227.

Change in OFCNV	\$437
Less: section 987 taxable income	(227)
Unrecognized section 987 gain 2022	\$210
Plus: net accumulated unrecognized section 987 gain from prior years	130
Net unrecognized section 987 gain	\$340

(iv) Operations in 2023. During 2023, Business A recognizes revenue of €252 from sales of finished goods. The related COGS is €140.80, reflecting a full liquidation of the 2022 inventory layer with a LIFO cost basis of \$10.80 and a partial liquidation of inventory from the 2021 layer with a LIFO cost basis of \$10.00. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2023 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2023, shows no liabilities and the following assets: currency of €422, the building with an adjusted basis of €720, the machine with an adjusted basis of €210, and a 2021 layer of ending inventory with a LIFO cost basis of €30, comprising raw materials and finished goods. The yearly average exchange rate for 2023 is €1 = \$3.50, and the spot rate on December 31, 2023 is €1 = \$4.00.

(A) Determination of income. Business A's income for 2023 is computed as follows:

<u>Item</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Sales revenue	€252	€1 = \$3.50 (yearly avg. rate-2023)	\$882
COGS before adjustments	140.80	€1 = \$3.50 (yearly avg. rate-2023)	\$492.80
Adjustment for cost recovery deductions (see calculation below)			(100.00)
Adjustment for LIFO liquidation (see calculation below)			(30.80)
Adjusted COGS			\$362.00
SG&A			
Depreciation on building (50%)	10	€1 = \$1.00 (historic rate-2020)	\$10
Salaries	10	€1 = \$3.50 (yearly avg. rate-2023)	35

Total SG&A	\$45
Section 987 net income	\$475

COGS Adjustments

Adjustment for cost recovery deductions

<u>Depreciation Amount</u>	<u>Historic Rate</u>	<u>2023 Yearly Avg. Rate</u>	<u>Difference in Translation Rates</u>	<u>Adjustment (Depreciation x Change in Rates)</u>
€10 (building)	1.00	3.50	(2.50)	(\$25)
€30 (machine)	1.00	3.50	(2.50)	<u>(\$75)</u>
Total adjustment for cost recovery deductions				(\$100)

Adjustment for LIFO liquidation

<u>LIFO Liquidation Layer</u>	<u>Historic Rate</u>	<u>2023 Yearly Avg. Rate</u>	<u>Difference in Translation Rates</u>	<u>Adjustment (Liquidated Layer x Change in Rates)</u>
€10.80 (2022)	2.50	3.50	(1.00)	(\$10.80)
€10 (2021)	1.50	3.50	(2.00)	<u>(\$20.00)</u>
Total adjustment for liquidation of LIFO layers				(\$30.80)

(B) Determination of OFCNV. The OFCNV of Business A for 2023 is determined under paragraph (e) of this section as follows:

OFCNV--End of 2023

<u>Assets</u>	<u>Amount in €</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Euros	€422	€1 = \$4.00 (year-end spot rate-2023)	\$1,688
Building	720	€1 = \$1.00 (historic rate-2020)	720
Machine	210	€1 = \$1.00 (historic rate-2020)	210
Inventory	30	€1 = \$1.50 (historic rate-2021)	<u>45</u>
Total assets			\$2,663

Liabilities

Total liabilities	\$0
2023 ending OFCNV	\$2,663

(C) Determination of net unrecognized section 987 gain or loss. The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(1) Step 1. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2023, less the OFCNV of Business A determined on the last day of 2022.

2023 ending OFCNV	\$2,663
Less: 2022 ending OFCNV	<u>(1,847)</u>
Change in OFCNV	\$816

(2) Step 6--Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2023, as determined above, is \$475.

Change in OFCNV	\$816
Less: section 987 taxable income	<u>(475)</u>
Unrecognized section 987 gain 2023	\$341
Plus: net accumulated unrecognized section 987 gain from prior years	<u>340</u>
Net unrecognized section 987 gain	\$681

**§1.987-5 Recognition of section 987 gain or loss.**

(a) Recognition of section 987 gain or loss by the owner of a section 987 QBU.

The taxable income of an owner of a section 987 QBU shall include the owner's section 987 gain or loss recognized with respect to the section 987 QBU for the taxable year.

Except as otherwise provided, for any taxable year the owner's section 987 gain or loss recognized with respect to a section 987 QBU shall equal:

(1) The owner's net unrecognized section 987 gain or loss with respect to the section 987 QBU determined under §1.987-4 on the last day of such taxable year (or, if earlier, on the day the section 987 QBU is terminated under §1.987-8); multiplied by

(2) The owner's remittance proportion for the taxable year, as determined under paragraph (b) of this section.

(b) Remittance proportion. The owner's remittance proportion with respect to a section 987 QBU for a taxable year shall equal:

(1) The remittance, as determined under paragraph (c) of this section, to the owner from the section 987 QBU for such taxable year; divided by

(2) The sum of

(A) The aggregate adjusted basis of the gross assets of the section 987 QBU as of the end of the taxable year that are reflected on its year-end balance sheet translated into the owner's functional currency as provided in §1.987-4(e)(2) and

(B) The amount of the remittance as determined under paragraph (c) of this section.

(c) Remittance--(1) Definition. A remittance shall be determined in the owner's functional currency and shall equal the excess, if any, of:

(i) The aggregate of all amounts transferred from the section 987 QBU to the owner during the taxable year, as determined in paragraph (d) of this section; over

(ii) The aggregate of all amounts transferred from the owner to the section 987 QBU during the taxable year, as determined in paragraph (e) of this section.

(2) Day when a remittance is determined. An owner's remittance from a section 987 QBU shall be determined on the last day of the owner's taxable year (or, if earlier, on the day the section 987 QBU is terminated under §1.987-8).

(3) Termination. A termination of a section 987 QBU as determined under §1.987-8 is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of such termination. See §1.987-8(e). Accordingly, the remittance proportion in the case of a termination is 1.

(d) Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year. For purposes of paragraph (c)(1)(i) of this section, the aggregate amount transferred from the section 987 QBU to the owner for the taxable year shall be the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under §1.987-4(d)(2). Solely for this purpose, the amount of liabilities transferred from the owner to the section 987 QBU, as determined in the owner's functional currency under §1.987-4(d)(5), shall be treated as a transfer of assets from the section 987 QBU to the owner in an amount equal to the amount of such liabilities.

(e) Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year. For purposes of paragraph (c)(1)(ii) of this section, the aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year shall be the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under §1.987-4(d)(3). Solely for this purpose, the amount of liabilities transferred from the section 987 QBU to the owner determined under §1.987-4(d)(4) shall be treated as a transfer of assets from the owner to the section 987 QBU in an amount equal to the amount of such liabilities.

(f) Determination of owner's adjusted basis in transferred assets--(1) In general. The owner's adjusted basis in an asset received in a transfer from a section 987 QBU

(whether or not such transfer is made in connection with a remittance, as defined in paragraph (c) of this section) shall be determined in the owner's functional currency under the rules prescribed in paragraphs (f)(2) and (f)(3) of this section.

(2) Marked asset. The basis of a marked asset shall be the amount determined by translating the section 987 QBU's functional currency basis of the asset, after taking into account §1.988-1(a)(10), into the owner's functional currency at the spot rate (as defined in §1.987-1(c)(1)) applicable to the date of transfer.

(3) Historic asset. The basis of a historic asset shall be the amount determined by translating the section 987 QBU's functional currency basis of the asset, after taking into account §1.988-1(a)(10), into the owner's functional currency at the historic rate for the asset (as defined in §1.987-1(c)(3)).

(g) Example. The following example illustrates the calculation of section 987 gain or loss under this section:

Example. (i) U.S. Corp, a domestic corporation with the dollar as its functional currency, operates in the United Kingdom through Business A, a section 987 QBU with the pound as its functional currency. During 2021, the following transfers took place between U.S. Corp and Business A. On January 5, 2021, U.S. Corp transferred to Business A \$300, which Business A used during the year to purchase services. On March 5, 2021, Business A transferred a machine to U.S. Corp. The pound adjusted basis of the machine when properly translated into dollars as described under §1.987-4(d)(2)(ii)(B) and paragraph (d) of this section is \$500. On November 1, 2021, Business A transferred pounds to U.S. Corp. The dollar amount of the pounds when properly translated as described under §1.987-4(d)(2)(ii)(A) and paragraph (d) of this section is \$2,300. On December 7, 2021, U.S Corp transferred a truck to Business A with an adjusted basis of \$2,000.

(ii) At the end of 2021, Business A holds assets, properly translated into the owner's functional currency pursuant to §1.987-4(e)(2), consisting of a computer with a pound adjusted basis equivalent to \$500, a truck with a pound adjusted basis equivalent to \$2,000, and pounds equivalent to \$2,850. In addition, Business A has a pound liability entered into in 2020 with Bank A. All such assets and liabilities are reflected on

the books and records of Business A. Assume that the net unrecognized section 987 gain for Business A as determined under §1.987-4 as of the last day of 2021 is \$80.

(iii) U.S. Corp's section 987 gain with respect to Business A is determined as follows:

(A) Computation of amount of remittance. Under paragraphs (c)(1) and (c)(2) of this section, U.S. Corp must determine the amount of the remittance for 2021 in the owner's functional currency (dollars) on the last day of 2021. The amount of the remittance for 2021 is \$500, determined as follows:

Transfers from Business A to U.S. Corp in dollars:

Machine	\$500
Pounds	<u>2,300</u>
Aggregate transfers from Business A to U.S. Corp	\$2,800

Transfers from U.S. Corp to Business A in dollars:

U.S. dollars	\$300
Truck	<u>2,000</u>
Aggregate transfers from U.S. Corp to Business A	\$2,300

Computation of amount of remittance:

Aggregate transfers from Business A to U.S. Corp	\$2,800
Less: aggregate transfers from U.S. Corp to Business A	<u>(2,300)</u>
Total remittance	\$500

(B) Computation of section 987 QBU gross assets plus remittance. Under paragraph (b)(2) of this section, Business A must determine the aggregate basis of its gross assets that are reflected on its year-end balance sheet translated into the owner's functional currency and must increase this amount by the amount of the remittance.

Computer	\$500
Pounds	2,850
Truck	<u>2,000</u>
Aggregate gross assets	\$5,350
Remittance	\$500
Aggregate basis of Business A's gross assets at end of 2021, increased by amount of remittance	\$5,850

(C) Computation of remittance proportion. Under paragraph (b) of this section, Business A must compute the remittance proportion by dividing the \$500 remittance amount by the \$5,850 sum of the aggregate basis of Business A's gross assets and the amount of the remittance. The resulting remittance proportion is 0.085.

(D) Computation of section 987 gain or loss. The amount of U.S. Corp's section 987 gain or loss that must be recognized with respect to Business A is determined under paragraph (a) of this section by multiplying the 0.085 remittance proportion by the \$80 of net unrecognized section 987 gain. U.S. Corp's resulting recognized section 987 gain for 2021 is \$6.80.

Par. 5 Sections 1.987-6 through 1.987-11 are added to read as follows:

\* \* \* \* \*

Sec.

1.987-6 Character and source of section 987 gain or loss.

1.987-7 Section 987 aggregate partnerships.

1.987-8 Termination of a section 987 QBU.

1.987-9 Recordkeeping requirements.

1.987-10 Transition rules.

1.987-11 Effective/applicability date.

\* \* \* \* \*

**§1.987-6 Character and source of section 987 gain or loss.**

(a) Ordinary income or loss. Section 987 gain or loss is ordinary income or loss for Federal income tax purposes.

(b) Character and source of section 987 gain or loss--(1) In general. With respect to each section 987 QBU, the owner must determine the character and source of section 987 gain or loss in the year of a remittance under the rules of this paragraph (b) for all purposes of the Internal Revenue Code, including sections 904(d), 907, and 954.

(2) Method required to characterize and source section 987 gain or loss. The owner must use the asset method set forth in §1.861-9T(g) to characterize and source section 987 gain or loss. In applying the asset method, the owner must take into account only the assets of the section 987 QBU and must consistently determine the value of the assets on the basis of either the tax book value or the fair market value of the assets. The modified gross income method described in §1.861-9T(j) cannot be used.

(3) Coordination with section 954. Solely for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D), section 987 gain or loss that is characterized pursuant to paragraph (b)(2) of this section by reference to assets that give rise to subpart F income shall be treated as foreign currency gain or foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation.

(c) Examples. The following examples illustrate the application of this section.

Example 1. CFC is a controlled foreign corporation as defined in section 957 with the Swiss franc (Sf) as its functional currency. CFC is the owner of Business A, a section 987 QBU that has the euro as its functional currency. For the year 2021, CFC recognizes section 987 gain of Sf10,000 under §1.987-5. Applying the rules of this section, Business A has average total assets of Sf1,000,000, which generate income as follows: Sf750,000 of assets that generate foreign source general limitation income under section 904(d)(1)(A), none of which is subpart F income under section 952; and Sf250,000 of assets that generate foreign source passive income under section 904(d)(1)(B), all of which is subpart F income. Under paragraph (b) of this section, Sf7,500 ( $\text{Sf}750,000/\text{Sf}1,000,000 \times \text{Sf}10,000$ ) of the section 987 gain will be characterized as foreign source general limitation income that is not subpart F income under section 952, and Sf2,500 ( $\text{Sf}250,000/\text{Sf}1,000,000 \times \text{Sf}10,000$ ) will be characterized as foreign source passive income that is characterized as foreign personal holding company income under section 954(c)(1)(D). All of the section 987 gain is treated as ordinary income.

Example 2. The facts are the same as in Example 1 except that: (a) CFC recognizes section 987 loss of \$40,000, \$10,000 of which is characterized under paragraph (b) of this section by reference to assets that give rise to subpart F income; and (b) CFC otherwise has \$12,000 of net foreign currency gain determined under §1.954-2(g) that is taken into account in determining the excess of foreign currency gain over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Under paragraph (b)(3) of this section, the \$10,000 section 987 loss characterized by reference to assets that give rise to subpart F income is treated as foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Accordingly, CFC will aggregate the \$10,000 section 987 loss with the \$12,000 net foreign currency gain and will have \$2,000 of net foreign currency gain characterized as foreign personal holding company income under section 954(c)(1)(D).

**§1.987-7 Section 987 aggregate partnerships.**

(a) In general. This section provides rules for determining an owner's share of the assets and liabilities of an eligible QBU that is owned indirectly, as described in §1.987-1(b)(4)(ii), through a section 987 aggregate partnership.

(b) [Reserved].

(c) Coordination with subchapter K. [Reserved].

**§1.987-8 Termination of a section 987 QBU.**

(a) Scope. This section provides rules regarding the termination of a section 987 QBU. Paragraph (b) of this section provides general rules for determining when a termination occurs. Paragraph (c) of this section provides exceptions to the general termination rules for certain transactions described in section 381(a). Paragraph (e) of this section describes certain effects of terminations. Paragraph (f) of this section contains examples that illustrate the principles of this section.

(b) In general. Except as provided in paragraph (c) of this section, a section 987 QBU terminates if the conditions described in one of paragraphs (b)(1) through (4) is satisfied.

(1) Trade or business ceases. A section 987 QBU ceases its trade or business. When a section 987 QBU ceases its trade or business is determined based on all the facts and circumstances, provided that an owner may continue to treat a section 987 QBU as a section 987 QBU for a reasonable period during the winding up of such trade or business, which period may in no event exceed two years from the date on which such QBU ceases its activities carried on for profit.

(2) Substantially all assets transferred. The section 987 QBU transfers substantially all (within the meaning of section 368(a)(1)(C)) of its assets to its owner. For purposes of this paragraph (b)(2), the amount of assets transferred from the section 987 QBU to its owner as a result of a transaction shall be reduced by the amount of assets transferred from the owner to the section 987 QBU pursuant to the same transaction. See Examples 2, 5, and 6 in paragraph (f) of this section.

(3) Owner no longer a CFC. A foreign corporation that is a controlled foreign corporation (as defined in section 957) that is the owner of a section 987 QBU ceases to be a controlled foreign corporation as a result of a transaction or series of transactions after which persons that were related to the corporation within the meaning of section 267(b) immediately before the transaction or series of transactions collectively own sufficient interests in the corporation such that the corporation would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b).

(4) Owner ceases to exist. The owner of the section 987 QBU ceases to exist (including in connection with a transaction described in section 381(a)).

(c) Transactions described in section 381(a)--(1) Liquidations. Notwithstanding paragraph (b) of this section, a termination does not occur when the owner of a section 987 QBU ceases to exist in a liquidation described in section 332, except in the following cases:

(i) The distributor is a domestic corporation and the distributee is a foreign corporation.

(ii) The distributor is a foreign corporation and the distributee is a domestic corporation.

(iii) The distributor and the distributee are both foreign corporations and the functional currency of the distributee is the same as the functional currency of the distributor's section 987 QBU.

(2) Reorganizations. Notwithstanding paragraph (b) of this section, a termination does not occur when the owner of the section 987 QBU ceases to exist in a reorganization described in section 381(a)(2), except in the following cases:

(i) The transferor is a domestic corporation and the acquiring corporation is a foreign corporation.

(ii) The transferor is a foreign corporation and the acquiring corporation is a domestic corporation.

(iii) The transferor is a controlled foreign corporation immediately before the transfer, the acquiring corporation is a foreign corporation that is not a controlled foreign corporation immediately after the transfer, and the acquiring corporation was related to the transferor within the meaning of section 267(b) immediately before the transfer.

(iv) The transferor and the acquiring corporation are foreign corporations and the functional currency of the acquiring corporation is the same as the functional currency of the transferor's section 987 QBU.

(d) [Reserved].

(e) Effect of terminations. A termination of a section 987 QBU as determined in this section is treated as a remittance of all the gross assets of the section 987 QBU to its owner immediately before the section 987 QBU terminates. Thus, except as otherwise provided in these regulations under section 987, a termination results in the recognition of any net unrecognized section 987 gain or loss of the section 987 QBU. See §1.987-5(c)(3).

(f) Examples. The following examples illustrate the principles of this section. Except as otherwise provided, U.S. Corp is a domestic corporation that has the U.S. dollar as its functional currency, and Business A is a section 987 QBU.

Example 1. Cessation of operations. (i) Facts. U.S. Corp is the owner of Business A, a sales office of U.S. Corp in Country X. Business A ceases sales activities on December 31, 2021. During 2022, Business A sells all of the assets used in its sales activities and winds up its business, settling outstanding accounts.

(ii) Analysis. Business A's trade or business ceases on December 31, 2021. The cessation of Business A's trade or business causes a termination of the Business A section 987 QBU under paragraph (b)(1) of this section on December 31, 2021, unless U.S. Corp chooses to continue to treat Business A as a section 987 QBU until completion of the wind-up activities in 2022. If U.S. Corp chooses to continue to treat Business A as a section 987 QBU during the wind-up of Business A, Business A section 987 QBU would terminate under paragraph (b)(1) of this section upon completion of the wind-up in 2022.

Example 2. Transfer of a section 987 QBU to a member of a consolidated group. (i) Facts. U.S. Corp, the owner of Business A, transfers all the assets and liabilities of Business A to DS, a domestic corporation all of the stock of which is owned by U.S. Corp, in a transaction qualifying under section 351. U.S. Corp and DS are members of the same consolidated group.

(ii) Analysis. Pursuant to §1.987-2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A for DS stock in a section 351 transaction, Business A is treated as transferring its assets and liabilities to U.S. Corp immediately before the transfer by U.S. Corp of the assets and liabilities to DS. Because a section 351 transaction is not a transaction described in section 381(a), the transfer of all of the assets of Business A to U.S. Corp causes a termination of the Business A section 987 QBU under paragraph (b)(2) of this section.

Example 3. Cessation of controlled foreign corporation status. (i) Facts. Foreign parent (FP) is a foreign corporation that owns all the stock of U.S. Corp, a domestic corporation. U.S. Corp owns all of the stock of FC, a controlled foreign corporation as defined in section 957. FC is the owner of Business A. FP contributes cash to FC in exchange for FC stock representing 60 percent of the voting power and value of all FC stock. FC no longer constitutes a controlled foreign corporation after the capital contribution.

(ii) Analysis. Because FC ceases to qualify as a controlled foreign corporation as a result of a transaction after which persons that were related to FC within the meaning of section 267(b) immediately before the transaction collectively own sufficient interests in FC such that the FC would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b), the Business A section 987 QBU terminates pursuant to paragraph (b)(3) of this section.

Example 4. Section 332 liquidation. (i) Facts. U.S. Corp owns all of the stock of FC, a foreign corporation. FC is the owner of Business A. Pursuant to a liquidation described in section 332, FC transfers all of its assets and liabilities to U.S. Corp.

(ii) Analysis. FC's liquidation causes a termination of the Business A section 987 QBU as provided in paragraph (b)(4) of this section because FC ceases to exist as a result of the liquidation. The exception for certain section 332 liquidations provided under paragraph (c)(1) of this section does not apply because U.S. Corp is a domestic corporation and FC is a foreign corporation. See paragraph (c)(1)(ii) of this section.

Example 5. Transfers to and from a section 987 QBU pursuant to the same transaction. (i) Facts. U.S. Corp owns 100 percent of DC1 and DC2, each a domestic corporation. DC1 owns Entity A, a DE that conducts a business (Business A) in Country X that constitutes a section 987 QBU of DC1. DC2 subsequently contributes property to Entity A in exchange for a 95 percent interest in Entity A. The property DC2 contributes to Entity A is used in the business conducted by Business A and is reflected on its books and records as provided under §1.987-2(b).

(ii) Analysis. (A) For general Federal income tax purposes, Entity A is converted to a partnership when DC2 contributes property to Entity A in exchange for a 95 percent interest in Entity A. DC2's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. DC1 is treated as contributing all of Business A to the partnership in exchange for a partnership interest. See Rev. Rul. 99-5 (situation 2), (1999-1 CB 434) and §601.601(d)(2) of this chapter. For purposes of this section, these deemed transactions are not taken into account. See §1.987-2(c) and §1.987-2(c)(10), Example 9.

(B) Under §1.987-1(b)(5)(i), Entity A is converted to a section 987 aggregate partnership when DC2 contributes property to Entity A in exchange for a 95 percent interest in Entity A because DC1 and DC2 own all the interests in partnership capital and profits, DC1 and DC2 are related within the meaning of section 267(b), and the requirements of §1.987-1(b)(5)(i)(B) are satisfied. Because DC2 is a partner in a section 987 aggregate partnership that owns Business A and because DC2 and Business A have different functional currencies, DC2's portion of the Business A assets constitutes a section 987 QBU of DC2.

(C) As a result of the conversion of Entity A to a partnership, DC2 acquires an allocable share of 95 percent of the assets of Business A, as determined under §1.987-7. Accordingly, under §1.987-2(c)(5), DC2 is treated as contributing 95 percent of its contributed property to its Business A section 987 QBU. In addition, DC2 is treated as transferring 5 percent of the contributed property to DC1, and DC1 is subsequently treated as transferring that property to DC1's Business A section 987 QBU. In addition, 95 percent of the original (pre-conversion) assets of Business A cease being reflected on the books and records of DC1's section 987 QBU. Under §1.987-2(b)(5), these amounts are treated as if they are transferred from DC1's section 987 QBU to DC1, and DC1 is treated as transferring these assets to DC2. DC2 is subsequently treated as transferring these assets to DC2's Business A section 987 QBU. The other 5 percent of the original (pre-conversion) assets are treated as remaining on the books and records of DC1's section 987 QBU and are not deemed to be transferred.

(D) For purposes of determining whether substantially all the assets of Business A were transferred from DC1's section 987 QBU as provided under paragraph (b)(2) of this section, the amount of assets transferred from Business A to DC1 under §1.987-2(c) (95 percent of the assets held by Business A before the contribution by DC2) must be reduced by the 5 percent of the assets contributed by DC2, which were treated as transferred from DC2 to DC1 and subsequently transferred from DC1 to its Business A section 987 QBU, as a result of the formation of the section 987 aggregate partnership. Accordingly, the amount of assets transferred from DC1's section 987 QBU for purposes of paragraph (b)(2) of this section is equal to 95 percent of the original (pre-conversion) assets minus 5 percent of DC2's contributed assets.

**Example 6. Deemed transfers to a CFC upon a check-the-box election.** (i) **Facts.** In 2021, U.S. Corp forms an entity in a foreign country, Entity A. Entity A owns Business A, which has the pound as its functional currency. Entity A forms Entity B in another foreign country. Entity B owns Business B, a section 987 QBU that has the euro as its functional currency. At the time of formation, Entity A and Entity B elect to be DEs. In 2026, Entity A files an election on Form 8832 to be classified as a corporation under §301.7701-3(g)(1)(iv) and becomes a CFC (FC) owned directly by U.S. Corp. FC has the pound as its functional currency.

(ii) **Analysis.** (A) Under §1.987-1(b)(4)(i), U.S. Corp is the owner of Business A and Business B. In 2026, when Entity A elects to be classified as a corporation, U.S. Corp is deemed to contribute the assets and liabilities of Business A and Business B to FC under section 351 in exchange for FC stock. Pursuant to §1.987-2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A and Business B for FC stock in a section 351 transaction, Business A and Business B are each treated as transferring their assets and liabilities to U.S. Corp immediately before U.S. Corp's transfer of such assets and liabilities to FC. The transfer of assets from Business A and Business B to U.S. Corp causes terminations of those section 987 QBUs under paragraph (b)(2) of this section. The assets and liabilities of Business A and Business B are now owned by FC, but because FC and Business A have the same functional currency, only Business B qualifies as a section 987 QBU to which section 987 applies.

(B) Terminations also would have occurred in 2026 if U.S. Corp had contributed Entity A and Entity B to an existing foreign corporation owned by U.S. Corp or to a newly created foreign corporation owned by U.S. Corp pursuant to a section 351 exchange because the transfer of all of the assets of Business A and Business B would cause terminations of those section 987 QBUs under paragraph (b)(2) of this section.

**Example 7. Sale of a section 987 QBU to a member of a consolidated group.** (i) **Facts.** U.S. Corp, the owner of Business A, sells all of the assets and liabilities of Business A to DS, a domestic corporation, in exchange for cash. U.S. Corp and DS are members of the same consolidated group. The cash received on the sale is recorded on the books of U.S. Corp.

(ii) **Analysis.** Pursuant to §1.987-2(c)(2)(i) and (ii), Business A is treated as transferring all of its assets and liabilities to U.S. Corp immediately before the sale by U.S. Corp to DS. As a result of this deemed transfer from Business A to U.S. Corp, the Business A section 987 QBU terminates under paragraph (b)(2) of this section.

### **§1.987-9 Recordkeeping requirements.**

(a) In general. A taxpayer that is an owner of a section 987 QBU shall keep a copy of each election made by the taxpayer in accordance with the rules of §1.987-1(g)(3) (if not required to be made on a form published by the Commissioner regarding section 987) and such reasonable records as are sufficient to establish the section 987 QBU's taxable income or loss and section 987 gain or loss.

(b) Supplemental information. An owner's obligation to maintain records under section 6001 and paragraph (a) of this section is not satisfied unless the following information is maintained in such records with respect to each section 987 QBU:

(1) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU in the functional currency of the section 987 QBU.

(2) The amount of assets and liabilities attributed to the section 987 QBU in the functional currency of the section 987 QBU.

(3) The exchange rates used to translate items of income, gain, deduction, or loss of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which such convention is determined.

(4) The exchange rates used to translate the assets and liabilities of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which such convention is determined.

(5) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU translated into the functional currency of the owner.

(6) The amount of assets and liabilities attributed to the section 987 QBU translated into the functional currency of the owner.

(7) The amount of assets and liabilities transferred by the owner to the section 987 QBU determined in the functional currency of the owner.

(8) The amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner.

(9) The amount of the unrecognized section 987 gain or loss for the taxable year.

(10) The amount of the net accumulated unrecognized section 987 gain or loss at the close of the taxable year.

(11) If a remittance is made, the computations determined under §1.861-9T(g) for purposes of sourcing and characterizing the remittance under §1.987-5.

(12) The transition information required to be determined under §1.987-10(e).

(c) Retention of records. The records required by this section, or records that support the information required on a form published by the Commissioner regarding section 987, must be maintained and kept at all times available for inspection by the Internal Revenue Service for so long as the contents thereof may become relevant in the administration of the Internal Revenue Code.

(d) Information on a dedicated section 987 form. The requirements of paragraph (b) of this section shall be satisfied if the taxpayer provides the specific information required on a form published by the Commissioner for this purpose.

#### **§1.987-10 Transition rules.**

(a) Scope. These transition rules shall apply to any taxpayer that is an owner of a section 987 QBU pursuant to §1.987-1(b)(4) on the transition date (as defined in §1.987-11(c)). Except as provided in paragraph (c) of this section, a taxpayer to which this section applies must transition from the method previously used to comply with section 987 (the “prior section 987 method”) to the method prescribed by these regulations pursuant to the fresh start transition method set forth in paragraph (b) of this section.

(b) Fresh start transition method--(1) In general. Pursuant to the fresh start transition method, and solely for purposes of this section, all section 987 QBUs of a taxpayer, other than section 987 QBUs subject to paragraph (c) of this section, are deemed to terminate on the day before the transition date. No section 987 gain or loss is determined or recognized as a result of the deemed termination. The owner of a section 987 QBU that is deemed to terminate under this section is treated as having transferred all of the assets and liabilities attributable to such QBU to a new section 987 QBU on the transition date. This deemed transfer of assets and liabilities is taken into account only for purposes of transitioning to these regulations under section 987 and shall not be taken into account in determining the amounts transferred from the owner to the section 987 QBU during the taxable year for purposes of §1.987-5(c)(1)(ii).

(2) Application of §1.987-4. For purposes of applying §1.987-4 with respect to a section 987 QBU described in paragraph (b)(1) of this section for the taxable year beginning on the transition date, the amount of assets and liabilities deemed transferred from the owner to the section 987 QBU on the transition date pursuant to paragraph (b)(1) of this section shall be determined by translating such assets and liabilities (without regard to whether the asset or liability is a marked item or a historic item) at the historic rate as determined under paragraph (b)(3) of this section.

(3) Determination of historic rate. For purposes of applying these regulations with respect to a section 987 QBU described in paragraph (b)(1) of this section for taxable years beginning on or after the transition date, the historic rate (as defined in §1.987-1(c)(3)) for an asset or liability deemed transferred under paragraph (b)(1) of this section from an owner to the section 987 QBU on the transition date shall be the historic rate under §1.987-1(c)(3) determined by reference to the date the assets were acquired

or liabilities entered into or assumed by the section 987 QBU deemed terminated (that is, without regard to the deemed termination or transfer described in paragraph (b)(1) of this section). However, if the owner is not able to determine reliably the historic rate for a particular asset or liability, then the historic rate must be determined based on reasonable assumptions (for example, assumptions about turnover and aging of accounts receivable), consistently applied.

(4) Example. The provisions of this paragraph (b) are illustrated by the following example. Exchange rate assumptions used in the example are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the effect of depreciation is not taken into account for purposes of this example.

Example. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns Business A, a U.K. branch with the pound as its functional currency. Business A was formed on January 1, year 1. U.S. Corp uses the method prescribed in the 1991 proposed section 987 regulations to determine the section 987 gain or loss of Business A. U.S. Corp contributed £6,000 to Business A on January 1, year 1. On the same day, Business A bought a truck for £4,000 and a computer for £1,000. Business A had profits determined under §1.987-1(b)(1)(i) through (iii) of the 1991 proposed section 987 regulations of £250 in each of year 1, year 2, and year 3, and the yearly average exchange rate was used in each of those years to translate Business A's profits under the 1991 proposed section 987 regulations. The yearly average exchange rate was £1 = \$1.10 in year 1, £1 = \$1.20 in year 2, and £1 = \$1.30 in year 3. Business A incurred a £50 loss in each of year 4 and year 5. Business A made no remittances to U.S. Corp in any year.

(ii) On January 1, year 5, Business A transitions to the method provided in these regulations pursuant to the fresh start transition method described in paragraph (b) of this section. Pursuant to paragraph (b)(1) of this section, Business A is deemed to terminate on December 31, year 4. However, no section 987 gain or loss is determined or recognized as a result of the deemed termination. Pursuant to paragraph (b)(2) of this section, for purposes of applying §1.987-4 with respect to Business A for year 5, the amount of assets and liabilities transferred from U.S. Corp to Business A on the transition date shall be determined by translating all of Business A's assets at the historic rates for those assets as determined under §1.987-1(c)(3) and paragraph (b)(3)

of this section. Because U.S. Corp is not able to determine reliably the historic rate for the pound currency it is deemed to transfer to Business A, U.S. Corp determines the historic rate for these pounds based on a last-in, first-out cash flow assumption. Thus, it is assumed that the £50 loss in each of year 4 and year 5 first reduces the £250 earned in year 3. Accordingly, for purposes of determining the amount of assets and liabilities deemed transferred from U.S. Corp to Business A on January 1, year 5, U.S. Corp translates Business A's assets and liabilities as follows:

<u>Assets</u>	<u>Amount in £</u>	<u>Translation Rate</u>	<u>Amount in \$</u>
Pounds	£1,000	£1 = \$1.10 (yearly average rate-year 1)	\$1,100
Pounds	250	£1 = \$1.10 (yearly average rate-year 1)	275
Pounds	250	£1 = \$1.20 (yearly average rate-year 2)	300
Pounds	150	£1 = \$1.30 (yearly average rate-year 3)	195
Truck	4,000	£1 = \$1.10 (yearly average rate-year 1)	4,400
Computer	1,000	£1 = \$1.10 (yearly average rate-year 1)	<u>1,100</u>
Total assets			\$7,370

Liabilities

Total liabilities \$0

(c) Transition of section 987 QBUs that applied the method set forth in the 2006 proposed section 987 regulations.--(1) In general. If, with respect to a particular section 987 QBU, a taxpayer's prior section 987 method was based on a reasonable application of the method described in the 2006 proposed section 987 regulations (REG-208270-86, 71 FR 52876), then the taxpayer shall apply these regulations under section 987 with respect to such section 987 QBU without regard to paragraph (b) of this section.

(2) Application of §1.987-4. For purposes of applying §1.987-4 with respect to a section 987 QBU described in paragraph (c)(1) for the taxable year beginning on the transition date, the owner functional currency net value of the section 987 QBU on the last day of the preceding taxable year under §1.987-4(d)(1)(B) shall be the amount that was determined under §1.987-4(d)(1)(A) of the 2006 proposed section 987 regulations for the preceding taxable year. Additionally, for purposes of applying §1.987-4 with

respect to a section 987 QBU described in paragraph (c)(1) for all taxable years that end after the transition date, the section 987 QBU's net unrecognized section 987 gain or loss for all prior taxable years under §1.987-4(c) shall take into account the aggregate of the amounts determined under §1.987-4(d) of the 2006 proposed section 987 regulations for taxable years for which the taxpayer applied the 2006 proposed section 987 regulations, reduced by the amounts taken into account under §1.987-5 of the 2006 proposed section 987 regulations upon a remittance for all such prior taxable years.

(3) Use of prior historic rate. For purposes of applying these regulations under section 987 with respect to historic items (as defined in §1.987-1(e)), other than inventory, that are reflected on the balance sheet of the section 987 QBU on the transition date, a taxpayer may use the same historic exchange rates as were used under the taxpayer's application of the 2006 proposed section 987 regulations in place of the historic rates that otherwise would be determined under §1.987-1(c)(3), provided that, for all taxable years that end after the transition date, the taxpayer does so with respect to all historic items (other than inventory) that are reflected on the balance sheet of the section 987 QBU on the transition date.

(4) Example. The provisions of this paragraph (c) are illustrated by the following example. Exchange rate assumptions used in the example are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the effect of depreciation is not taken into account for purposes of this example.

Example. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns Business A, a U.K. branch with the pound as its functional currency. Business A was formed on January 1, year 1. U.S. Corp uses a reasonable

application of the method described in the 2006 proposed section 987 regulations to determine the section 987 gain or loss of Business A. On January 1, year 5, Business A transitions to the method provided in these regulations pursuant to the method described in this paragraph (c). Business A's opening balance sheet on January 1, year 5, includes pounds, a truck acquired in year 2, inventory accounted for under the FIFO method, and no liabilities. These assets remain on the balance sheet on December 31, year 5.

(ii) Pursuant to paragraph (c)(3) of this section, U.S. Corp chooses to use the same historic exchange rates as were used under its application of the 2006 proposed regulations in place of the historic rates prescribed under §1.987-1(c)(3) for purposes of applying these regulations with respect to historic items (other than inventory) held on the transition date.

(iii) The pounds are marked items under §1.987-1(d). Because the pounds are marked items, for purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to §1.987-4(e), the pounds are translated into dollars using the spot rate (as defined in §1.987-1(c)(1)) applicable to the last day of year 5.

(iv) The truck held on Business A's balance sheet on January 1, year 5, is a historic item under §1.987-1(e). For purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to §1.987-4(e), the basis of the truck is translated into dollars using the spot rate on the day the truck was acquired in year 2, as determined under §1.987-1(c)(3) of the 2006 proposed section 987 regulations. If U.S. Corp had not chosen pursuant to paragraph (c)(3) of this section to use the same historic exchange rates as were used under its application of the 2006 proposed regulations, the basis of the truck would have been translated into dollars using the historic rate described in §1.987-1(c)(3), which is the yearly average exchange rate for year 5.

(v) The inventory held on Business A's balance sheet on January 1, year 5, is a historic item under §1.987-1(e). For purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to §1.987-4(e), the FIFO cost basis of the inventory is translated into dollars using the historic rate, which pursuant to §1.987-1(c)(3)(i)(B) is the yearly average exchange rate for year 5.

(vi) Pursuant to paragraph (c)(3) of this section, for purposes of applying §1.987-4 with respect to Business A for year 5, the owner functional currency net value of Business A on the last day of year 4 under §1.987-4(d)(1)(B) is the amount that was determined under §1.987-4(d)(1)(A) of the 2006 proposed section 987 regulations for year 4. Additionally, Business A's net unrecognized section 987 gain or loss for all prior years under §1.987-4(c) shall take into account the aggregate of the amounts

determined under §1.987-4(d) of the 2006 proposed section 987 regulations for year 1 through year 4, reduced by the amounts taken into account under §1.987-5 of the 2006 proposed section 987 regulations upon a remittance for all such prior taxable years.

(d) Adjustments to avoid double counting. If a difference between the treatment of any item under these regulations and the treatment of the item under the taxpayer's prior section 987 method would result in income, gain, deduction or loss being taken into account more than once, then the net unrecognized section 987 gain or loss of the section 987 QBU, as determined under §1.987-4(b) for the first taxable year for which these regulations apply, shall be adjusted to account for the difference.

(e) Reporting--(1) In general. Except as otherwise provided in this paragraph (e), the taxpayer must attach a statement titled "Section 987 Transition Information" to its timely filed return for the first taxable year to which these regulations under section 987 apply providing the following information:

(i) A description of each section 987 QBU to which these rules apply, the section 987 QBU's owner, the section 987 QBU's principal place of business, and a description of the prior section 987 method used by the taxpayer to determine section 987 gain or loss with respect to the section 987 QBU.

(ii) Any assumptions used by the taxpayer for determining the exchange rates used to translate the amount of assets and liabilities transferred to the section 987 QBU on the transition date, as provided in paragraph (b)(3) of this section.

(iii) With respect to each section 987 QBU subject to paragraph (c) of this section, a statement regarding whether historic items (as defined in §1.987-1(c)(3)) are translated pursuant to paragraph (c)(2) of this section at the same historic rates as were

used under the taxpayer's application of the 2006 proposed regulations or at the historic rates determined under §1.987-1(c)(3).

(iv) With respect to each section 987 QBU with respect to which an adjustment is made pursuant to paragraph (d) of this section, a description of the adjustment and the basis for the computation of such adjustments.

(2) Attachments not required where information is reported on a form. Paragraph (e) of this section shall not apply to the extent the information described in such paragraph is required to be reported on a form published by the Commissioner.

**§1.987-11 Effective/applicability date.**

(a) In general. Except as otherwise provided in this section, §§1.987-1 through 1.987-10 shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016.

(b) Application of these regulations to taxable years beginning after December 7, 2016. A taxpayer may apply these regulations under section 987 to taxable years beginning after December 7, 2016, provided the taxpayer consistently applies these regulations to such taxable years with respect to all section 987 QBUs directly or indirectly owned by the taxpayer on the transition date (as defined in paragraph (b)(2) of this section) as well as all section 987 QBUs directly or indirectly owned on the transition date by members that file a consolidated return with the taxpayer or by any controlled foreign corporation, as defined in section 957, in which a member owns more than 50 percent of the voting power or stock value, as determined under section 958(a).

(c) Transition date. The transition date is the first day of the first taxable year to which these regulations under section 987 are applicable with respect to a taxpayer under this section.

Par. 6. Section 1.988-0 is amended by adding an entry for §1.988-1(a)(4).

§1.988-0 Taxation of gain or loss from a section 988 transaction; Table of Contents.

\* \* \* \* \*

§1.988-1 Certain definitions and special rules.

(a) \* \* \*

(4) Treatment of assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU.

\* \* \* \* \*

Par. 7. Section 1.988-1 is amended by:

1. Adding paragraph (a)(4).
2. Revising paragraph (a)(10)(ii).
3. Adding two sentences to the end of paragraph (i).

The additions and revision read as follows:

§1.988-1 Certain definitions and special rules.

(a) \* \* \*

(4) Treatment of assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU--(i) Scope. This paragraph (a)(4) applies to assets and liabilities of a section 987 aggregate partnership as defined in §1.987-1(b)(5), or of an entity disregarded as an entity separate from its owner for Federal income tax purposes (DE), that are not attributable to an eligible QBU as defined in §1.987-1(b)(3).

(ii) Section 987 Aggregate Partnerships. For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a section 987 aggregate partnership, the owners of the section 987 aggregate partnership (within the meaning of

§1.987-1(b)(4)) shall be treated as owning their share of such assets and liabilities.

Section 1.987-7(b) shall apply for purposes of determining an owner's share of such assets or liabilities.

(iii) Disregarded entities. For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a DE, the owner of the DE (within the meaning of §1.987-1(b)(4)) shall be treated as owning all such assets and liabilities.

(iv) Example. The following example illustrates the application of paragraph (a)(4) of this section:

Example. Liability held through a section 987 aggregate partnership. (i) Facts. P, a foreign partnership, has two equal partners, X and Y. X is a domestic corporation with the dollar as its functional currency. Y is a foreign corporation wholly owned by X that has the yen as its functional currency. P is a section 987 aggregate partnership. On January 1, 2021, P borrowed yen and issued a note to the lender that obligated P to pay interest and repay principal to the lender in yen. Also on January 1, 2021, P used the yen it borrowed from the lender to acquire all of the stock of F, a foreign corporation, from an unrelated person. P also holds an eligible QBU (within the meaning of §1.987-1(b)(3)) that has the yen as its functional currency. P maintains one set of books and records. The assets and liabilities of the eligible QBU are reflected on the books and records of P as provided under §1.987-2(b). The F stock held by P, and the yen liability incurred to acquire the F stock, are also recorded on the books and records of P but, pursuant to §1.987-2(b)(2)(i), are not considered to be reflected on the books and records of the eligible QBU for purposes of section 987.

(ii) Analysis. X's portion of the assets and liabilities of the eligible QBU owned by P is a section 987 QBU. Y's portion of the assets and liabilities of the eligible QBU owned by P is not a section 987 QBU because Y and the eligible QBU have the same functional currency. Because the F stock and yen-denominated liability incurred to acquire such stock are not considered reflected on the books and records of the eligible QBU, they are not subject to section 987. In addition, because the F stock and the yen-denominated liability incurred to acquire such stock are held by P (but not attributable to P's eligible QBU), X and Y are treated as owning their respective shares of such stock and liability pursuant to §1.988-1(a)(4)(ii) for purposes of applying section 988. As a result, P's becoming the obligor on the portion of the yen-denominated note that is treated as an obligation of X is a section 988 transaction pursuant to paragraphs

(a)(1)(ii), (a)(2)(ii) and (a)(3) of this section. Similarly, the dispositions of yen to make payments of interest and principal on the liability, to the extent such yen are treated as owned by X under paragraph (a)(4)(ii) of this section, are section 988 transactions under paragraphs (a)(1)(i) and (a)(3) of this section. To the extent the yen are treated as owned by the eligible QBU, see §1.987-2(c) for the treatment of the payment of yen as a transfer from the eligible QBU to X. P's becoming the obligor on Y's portion of the yen-denominated note, and Y's portion of the yen disposed of in connection with payments on such note, are not section 988 transactions because Y has the yen as its functional currency.

\* \* \* \* \*

(10) \* \* \*

(ii) Certain intra-taxpayer transfers of section 988 transactions that result in the recognition of section 988 gain or loss--(A) In general. Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section entered into with another taxpayer shall be realized upon a transfer (as defined under §1.987-2(c)) of such currency or item from an owner to a section 987 QBU or from a section 987 QBU to an owner if as a result of such transfer --

(1) The currency or item loses its character as nonfunctional currency or as an item described in paragraph (a)(2) of this section; or

(2) The source of the exchange gain or loss could be altered absent the application of paragraph (a)(10)(ii)(B) of this section.

(B) Computation of exchange gain or loss. Exchange gain or loss described in section (a)(10)(ii)(A) of this section shall be computed in accordance with §1.988-2 (without regard to §1.988-2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use a translation rate that is consistent with the translation conventions of

the section 987 QBU to or from which, as the case may be, the item is being transferred. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner may defer such gain or loss.

\* \* \* \* \*

(i) \* \* \* Generally, the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987-11(b) a taxpayer applies §§1.987-1 through 1.987-11 beginning in a taxable year prior to the earliest taxable year described in §1.987-11(a), then the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

Par. 8. Section 1.988-4 is amended by revising paragraph (b)(2) to read as follows:

§1.988-4 Source of gain or loss realized on a section 988 transfer

\* \* \* \* \*

(b) \* \* \*

(2) Proper reflection on the books of the taxpayer or qualified business unit--(i) In general. For purposes of paragraph (b)(1) of this section, the principles of §1.987-2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books and records of a qualified business unit.

(ii) Effective/applicability date. Generally, paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987-11(b) a taxpayer

applies §§1.987-1 through 1.987-11 beginning in a taxable year prior to the earliest taxable year described in §1.987-11(a), then paragraph (b)(2)(i) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

\* \* \* \* \*

Par. 9. Section 1.989(a)-1 is amended by revising paragraph (b)(2)(i) and adding paragraphs (b)(4) and (d)(3) and (4) to read as follows:

§1.989(a)-1 Definition of a qualified business unit.

(b) \* \* \*

(2) \* \* \*

(i) Persons--(A) Corporations. A corporation is a QBU.

(B) Individuals. An individual is not a QBU.

(C) Partnerships. A partnership, other than a section 987 aggregate partnership as defined in §1.987-1(b)(5), is a QBU.

(D) Trusts and estates. A trust or estate is a QBU of a beneficiary.

\* \* \* \* \*

(4) Effective/applicability date. Generally, the revisions to paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987-11(b) a taxpayer applies §§1.987-1 through 1.987-11 beginning in a taxable year prior to the earliest taxable year described in §1.987-11(a), then the effective date of the revisions to paragraph (b)(2)(i) of this section with respect to the taxpayer shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

\* \* \* \* \*

(d) \* \* \*

(3) Proper reflection on the books of the taxpayer or qualified business unit. The principles of §1.987-2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books of a qualified business unit (and therefore is attributable to such unit).

(4) Effective/applicability date. Generally, the revisions to paragraph (d)(3) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to §1.987-11(b) a taxpayer applies §§1.987-1 through 1.987-11 beginning in a taxable year prior to the earliest taxable year described in §1.987-11(a), then the revisions to paragraph (b)(2)(i) of this section shall apply with respect to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

\* \* \* \* \*

**§1.989(c)-1 [Removed]**

Par. 10. Section 1.989(c)-1 is removed.

PART 602 -- OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

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CFR part or section where  
identified and described

Current OMB Control No.

\* \* \* \* \*

1.987-1

1545-2265

1.987-3

1545-2265

1.987-9

1545-2265

1.987-10

1545-2265

\* \* \* \* \*

John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: November 14, 2016

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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