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New York State Bar Association
Tax Section

Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss

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Contents

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This report[1] provides observations and recommendations regarding the announcement in Notice 2017-57[2] (the "***Notice***") that the Department of the Treasury ("***Treasury***") and the Internal Revenue Service (the "***IRS***") are considering changes to the final and temporary regulations under section 987[3] (the "***2016 Regulations***").[4] The Notice provides that Treasury and the IRS are considering changes that would allow taxpayers to elect to apply alternative rules for determining section 987 gain or loss as well as alternative rules for transitioning from one method of applying section 987 to another.

This report provides comments with respect to (i) alternative approaches for determining current taxable income and measuring unrealized section 987 gain or loss arising from a taxpayer's investment in a "qualified business unit" (a "***QBU***"), [5] (ii) alternative approaches with respect to the timing of section 987 loss realization and recognition, and (iii) a change to the transition rule. In addition, this report briefly revisits a comment we made with respect to

[1] The principal drafter of this report is Jeffrey Maddrey. Significant contributions in the drafting of this report were provided by Peter Connors and Shun Tosaka. Helpful comments were provided by Ed Gonzalez, Dina Kali, and Yaron Reich. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] 2017-42 I.R.B. 324.

[3] Unless otherwise noted, all section references are to sections of the Internal Revenue Code of 1986, as amended (the "***Code***"), and all references to regulations are to the Treasury regulations thereunder.

[4] T.D. 9795 (December 8, 2016).

[5] Section 989; Treas. Reg. § 1.989-1(a)(1). The 2016 Regulations define a "section 987 QBU" as a QBU that has a functional currency different than its owner. Any reference to QBU in this Report is a reference to a section 987 QBU as defined in Treas. Reg. § 1.987-1(b)(2).

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deemed terminations of QBUs in our 2008 Report[6] with respect to the 2006 Notice of Proposed Rulemaking (the "***2006 Proposed Regulations***").[7]

We are in favor of changes that would allow one (or more) alternative, less burdensome set(s) of rules for determining current taxable income from, and unrealized section 987 gain or loss with respect to, a QBU. In our view, the most appropriate approach would be to allow taxpayers to apply a "profit and loss" method along the lines of that described in the 1991 Notice of Proposed Rulemaking (the "***1991 Proposed Regulations***")[8] with certain adjustments. With respect to the timing of section 987 loss realization and recognition, we understand Treasury and the IRS have concerns with allowing realization and recognition of section 987 loss to be determined solely by reference to distributions of assets from the QBU to its owner ("***remittances***") and therefore are considering exercising the authority in section 989(c)(2) to limit the recognition of loss in certain cases. We recommend a "lookback" loss deferral rule under which section 987 gain or loss realized upon a remittance would be recognized currently only to the extent of prior realized section 987 gains from the same QBU. Finally, we are in favor of a change to the existing transition rule to ensure that items of economic gain or loss remain in the US federal income tax base and are not lost via the transition.

I. SUMMARY OF RECOMMENDATIONS

Our recommendations, discussed in greater detail in section III of this Report, are summarized below.

1. The IRS and Treasury should allow taxpayers to elect to determine taxable income arising from a QBU by reference to a "profit and loss" method similar to

[6] New York State Bar Ass'n Tax Section, *Report on Proposed Regulations Under Section 987* (Report No. 1140, Jan. 3, 2008) (the "***2008 Report***")

[7] 71 Fed. Reg. 52876 (Sept. 7, 2006), corrected, 71 Fed. Reg. 77654 (Dec. 27, 2006).

[8] 56 Fed. Reg. 48457 (Sept. 25, 1991).

that described in the 1991 Proposed Regulations. Under this approach, taxable income arising from the QBU's activities would be determined entirely in the QBU's functional currency and then translated into dollars. Unrealized section 987 gain or loss (economic gain or loss attributable to exchange-rate movements) would be measured by reference to the owner's net investment in the QBU. Section 987 gain or loss would be realized and recognized as remittances are made (subject to potential deferral rules discussed below). An elective regime of this type is preferable to the method in the 2016 Regulations because it (i) is significantly easier to implement, (ii) more accurately measures the portion of the owner's income that is attributable to currency fluctuations, and (iii) is far more consistent with the statutory text and legislative history.

2. Consideration could be given to allowing taxpayers to elect to determine unrealized section 987 gain or loss by reference to the retained earnings of the QBU rather than by reference to the owner's net investment in the QBU – a so-called "earnings only" approach. Although an "earnings only" approach is less economically accurate than a "net investment" approach, it has the same administrative ease, economic accuracy, and statutory consistency advantages over the method required by the 2016 Regulations.

3. To address the perceived ability of owners to selectively realize section 987 loss through a remittance, consideration could be given to one or more rules that would defer loss recognition, notwithstanding a remittance. Possible deferral regimes include: (i) a complete deferral of section 987 gain <u>and</u> loss until the QBU is terminated or otherwise disposed of, (ii) a carryforward approach where realized section 987 loss is deferred until a later period in which section 987 gain is realized, or (iii) a lookback approach where realized section 987 loss is recognized only to the extent of previously realized section 987 gains. We recommend the lookback approach.

4. The "fresh start" transition rule of the 2016 Regulations should be withdrawn and replaced. A new transition rule should ensure that, upon an owner's transition from one method of computing section 987 gain or loss to another, the unrealized

section 987 gain or loss immediately before the transition would be reflected in the opening balance of unrealized section 987 gain or loss immediately after the transition.

5. The regulations should be amended to provide that a QBU does not terminate upon the transfer of the QBU to a corporation having the same functional currency as the transferor where the transfer is otherwise afforded non-recognition protection under section 351.

II. BACKGROUND[9]

A. Subpart J

As part of the Tax Reform Act of 1986,[10] Congress added subpart J to the Code to address the treatment of certain transactions denominated in a foreign currency. Subpart J provides two different regimes – those of section 987 and section 988.

Section 988 applies to individual transactions (referred to as "***section 988 transactions***") denominated in or determined by reference to a foreign currency, including investments in foreign currency, holding or issuing debt instruments denominated in a foreign currency, and entering into certain derivatives of foreign currency itself and/or foreign currency-denominated debt such as futures, forwards, options and notional principal contracts.[11] Section 988 and the regulations thereunder provide rules for determining the timing, character, and source of income from section 988 transactions on a transaction-by-transaction basis. Section 988 can be thought of as a "separate transaction method" because each section 988 transaction is tax accounted on a separate basis.

[9] For more complete background, see 2008 Report at 5-34.
[10] P.L. 99-514, 100 Stat. 2085 (Oct. 22, 1986).
[11] Section 988(c)(1); Treas. Reg. § 1.988-1(a).

Section 987 applies to business activities carried on in a currency environment different than the taxpayers own functional currency.[12] Specifically, section 987 generally applies where a taxpayer (referred to as the "***owner***") carries on a trade or business that operates in a non-US dollar environment and therefore maintains its non-tax underlying books and records in the currency of its economic environment (its "functional currency").[13] The activities of the trade or business as well as the assets and liabilities used in it (with certain exceptions) constitute a "section 987 QBU."[14]

Often, given the amount of transactions entered into and the fact that the underlying books and records are maintained in the QBU's functional currency, it is impractical (if not impossible) to determine the owner's taxable income arising from the QBU in the owner's functional currency. In enacting section 987, Congress accepted the idea that the starting point for determinations of taxable income arising from a QBU must be the QBU's non-tax books and records, specifically its "profit and loss" statement maintained in the QBU's functional currency, in large part because it is often impractical to apply any other approach. The method of accounting in section 987 is sometimes referred to as the "profit and loss" method because it starts with the "profit and loss" statement of the QBU.[15]

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[12] The "functional currency" of a QBU is the currency of the economic environment in which a significant part of the QBU's activities is conducted provided that the QBU keeps its books and records in such currency. See Treas. Reg. § 1.985-1(c)(1).

[13] For ease of discussion, we will assume the owner has the US dollar as its functional currency. To the extent the owner is a foreign corporation or individual, it is possible that the owner could itself have a functional currency different than the US dollar.

[14] Treas. Reg. § 1.987-1(b)(2).

[15] Prior to the enactment of section 987, there were two general approaches to tax accounting for business activities conducted in a foreign currency – the "profit and loss" method or the "net worth" method (sometimes referred to as the "balance sheet" method). *See* Rev. Rul. 75-107, 1975-1 C.B. 32, obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388 ("profit and loss" method) and Rev. Rul. 75-106, 1975-1 C.B. 31, obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388 ("net worth" method).

Importantly, section 987 is more than an "aggregate" version of section 988. Section 988 is limited in scope and applies only to "section 988 transactions" – cash, debt, and derivative positions in foreign currency. Section 987, by contrast, applies to the entire business activities of a QBU, regardless of whether the individual transactions that comprise the activities of the business would constitute section 988 transactions if carried on directly by the owner of the QBU. For example, under section 987, purchases and sales of property where the price is determined in the QBU's functional currency generate gains and losses determined in the QBU's functional currency. If these same activities were carried on directly by the owner, the purchases and sales transactions themselves would be tax accounted for in dollars. Section 988 would apply only to cash on hand, payables and receivables. Section 988 would not apply to the property transactions themselves because they are not "section 988 transactions." Section 987, by contrast, does apply to the property transactions for many reasons, including most practically, the fact that there is usually no practical way to account for them separately for tax purposes where there do not exist underlying books of original entry kept in dollars.

B. Section 987

Section 987 itself is concise. It describes the "profit and loss" method in three sparse rules: (1) determine taxable income at the QBU level in the QBU's functional currency, (2) translate this amount into dollars at an appropriate rate, and (3) make proper adjustments for contributions and remittances. The legislative history described the mandate to determine taxable income at the QBU level as the "profit and loss" method.[16]

The first two rules are straightforward; the third rule, less so. The third rule clearly contemplates that "remittances" will trigger unrealized section 987 gain or loss but it does not

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[16] S. REP. NO. 99-313, 1986-3 C.B. (Vol. 3), at 470; *see* CONF. REP. NO. 99-841 Vol. II, 1986-3 C.B. (Vol. 4) at II-673 to II 676.

delineate precisely how.[17] The House Report stated that a remittance should trigger "gains and losses inherent in functional currency or other property remitted to the home office" in a manner that would generally treat activities conducted in branch form similar to those conducted through a subsidiary.[18] The Conference Report was more specific: "any remittance of property (not just currency) will trigger exchange gain or loss inherent in accumulated earnings or branch capital."[19]

C. The 1991 Proposed Regulations

In 1991, the IRS and Treasury released proposed regulations under section 987. Conceptually, the section 987 tax accounting framework can be divided into three parts: (1) determining the current taxable income arising from the QBU's activities for purposes of inclusion on the owner's return, (2) tracking unrealized section 987 gain or loss inherent in the owner's investment in the QBU, and (3) determining the portion of the unrealized section 987 gain or loss that must be realized and recognized upon a remittance.

1. Determining taxable income arising from QBU activities

The 1991 Proposed Regulations provided that the taxable income of the QBU was to be determined on a "profit and loss" method that follows section 987(1) and (2). The regulations required the taxpayer to start with the non-tax profit and loss statement in the functional currency of the QBU; to make book-to-tax adjustments with respect to this statement, again in the functional currency of the QBU; and then to translate the taxable income at the weighted average exchange rate for the year.[20]

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[17] Section 987(3)(B) provides source and character rules for recognized section 987 gain or loss. Section 989(c)(2) authorizes regulations limiting loss recognition upon remittances in certain situations.

[18] H.R. REP. NO. 99-426, 1986-3 C.B.(Vol. 2) at 469-70. *See also* S. REP. NO. 99-313, *supra*, at 455.

[19] CONF. REP. NO. 99-841 Vol. II, *supra* note 16, at II-675.

[20] 1991 Prop. Treas. Reg. § 1.987-1(b).

2. Determining unrealized section 987 gain or loss

The 1991 Proposed Regulations provided rules for determining the portion of economic gain or loss from the taxpayer's net investment in the QBU attributable to changes in exchange rates as well as rules governing the timing of section 987 gain or loss recognition. These rules required the owner to track two accounts with respect to each QBU – a "***basis pool***" and an "***equity pool***." The basis pool is denominated in the owner's functional currency (we are assuming dollars) and measures the net tax basis of the owner's investment in the QBU. The equity pool is denominated in the QBU's functional currency and measures the same amount (the owner's net investment in the QBU) in the QBU's functional currency.[21] At any given time, the unrealized section 987 gain or loss attributable to the owner's investment in the QBU is simply the difference between the value of the equity pool translated into dollars at the current spot rate and the basis pool. Thus, for example, consider a situation where an owner forms a QBU by contributing $1,000 and the QBU uses the contributed capital to purchase property (and/or hold as working capital). If on the date of the contribution the USD-to-FC exchange rate is $1.20 : 1.00 FC, the owner will have an initial basis pool of $1,000 and an initial equity pool of 833 FC ($1000 x 1.00 FC/$1.20). If nothing happens except the FC appreciates 10% against the dollar such that the exchange rate is now $1.32: 1.00 FC, the pool balances would reflect a $100 unrealized section 987 gain determined as follows:

Unrealized section 987 gain or loss = (Equity pool * USD/FC) – Basis pool

= (833 FC * $1.32/1FC) – $1000.

= $100

[21] 1991 Prop. Treas. Reg. § 1.987-2(a)(1).

The 1991 Proposed Regulations adjust the pool balances upon (i) contributions, (ii) the owner's inclusions of taxable income (or loss) arising from QBU activities, and (iii) remittances.[22] A contribution is a transfer of property or cash to the QBU that increases the owner's net investment in the QBU. As illustrated above, the owner increases the dollar basis pool by the amount of cash contributed or its adjusted basis in the property contributed. The owner increases the FC equity pool by the basis pool amount translated into FC at the spot rate on the date of contribution. Taxable income from the QBU increases the owner's net investment in the QBU (or in the case of a loss reduces its net investment). Thus, the dollar basis pool is increased (decreased) by the dollar amount of taxable income (loss) for the year and the FC equity pool is increased (decreased) by the FC amount of taxable income (loss).

Stated a different way, contributions and taxable income inclusions increase the owner's net investment in the QBU. These increases are reflected in the dollar basis pool and FC equity pools. Also, as mentioned above, the unrealized section 987 gain or loss at any point in time can be observed by converting the equity pool into dollars at the spot rate and comparing that amount to the dollar basis pool.

It is worth observing that transactions within the QBU itself impact the owner's net investment only to the extent they generate taxable income (or loss) measured in FC. If the QBU invests 1,000 FC in property that appreciates to 1,500 FC, the QBU has an unrealized gain (measured in its currency) of 500 FC. This gain does not impact the pools until it is realized and reflected in taxable income. Only when it is realized and therefore included in taxable income does it impact the pools. On these numbers, the realized gain of 500 FC would be reflected in the owner's taxable income for the year, determined by translating it into dollars at the average

[22] 1991 Prop. Treas. Reg. § 1.987-2(c)(1) and (2).

rate for the year.[23] In addition, the realized gain increases the FC equity pool by 500 FC and the dollar basis pool by, in effect, the same amount included in income -- the dollar value of $500 FC translated at the average exchange rate for the year.

3. Realization and recognition of section 987 gain or loss

A remittance is a transfer of property from the QBU to the owner. Remittances, by definition, reduce the owner's net investment in the branch. A remittance triggers realization and recognition of a portion of the unrealized section 987 gain or loss and a corresponding adjustment to the pool balances.

The amount of section 987 gain or loss realized and recognized is equal to the product of (i) the unrealized section 987 gain or loss at the time of the remittance and (ii) the percentage of the QBU balance sheet (measured by adjusted basis in the QBU's functional currency) remitted. Thus, if the QBU has total adjusted basis in its assets of 2,000 FC and it remits to the owner cash or property with an adjusted basis of 500 FC (contracting its tax-basis balance sheet by 25%), the owner must realize and recognize 25% of the unrealized section 987 gain or loss. The dollar basis pool and functional currency equity pool are adjusted to reflect the portion of the pools used to compute the realized section 987 gain or loss and the transferred asset takes a dollar adjusted basis in the owner's hands equal to the QBU's functional-currency adjusted basis translated into dollars at the spot rate. Thus, the effect of the remittance is to trigger realization and recognition of the unrealized section 987 gain or loss that corresponds to the percentage contraction of the net investment in the QBU.

Finally, under the 2006 Proposed Regulations, the termination of a QBU triggers 100% of the unrealized section 987 gain or loss.

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[23] Technically, the 500 FC of realized gain is a component of the QBU's overall taxable income for the year, determined in FC. This overall taxable income is then translated into dollars at the average exchange rate for the year.

4. Later IRS Concerns with the 1991 Proposed Regulations

In the Preamble to the 2006 Proposed Regulations (and Notice 2000-20[24] which preceded it), the IRS and Treasury articulated two fundamental concerns: one related to the "base" of assets and liabilities that give rise to section 987 gain or loss; the other related to the use of remittances to determine the "timing" of section 987 gain or loss recognition.

The IRS and Treasury's fundamental concern was with respect to the base of items that give rise to section 987 gain or loss. In particular, the preamble asserted that property (other than property that would be considered a section 988 transaction if held directly by the owner of a QBU) does not as an economic matter change in dollar value as dollar-functional currency exchange rates change. Because this type of property was not viewed as sensitive to exchange rate movements, the IRS asserted that it ought not to give rise to section 987 gain or loss for tax purposes. As discussed below, this belief about underlying economics led to the concept of "historic" and "marked" items at the heart of the 2006 Proposed Regulations and now in the 2016 Final Regulations. The Preamble asserted that the IRS "has faced many cases in which taxpayers have claimed substantial non-economic exchange losses largely on the basis of the 1991 Proposed Regulations."[25]

The second concern regarded the use of remittances to drive realization of recognition. The IRS was concerned that tying realization and recognition to remittances effectively made recognition (especially loss recognition) elective. After all, remittances are transfers entirely within a single taxpayer. In addition, the IRS expressed a concern that some remittances did not appear to truly contract the owner's net investment. In particular, the Notice indicated the IRS was concerned with remittances that did not reflect true contractions in QBU assets because there

[24] 2001-1 C.B. 851.

[25] 71 Fed. Reg. 52876 (Sept. 7, 2006), at 52879.

also existed close-in-time contributions, effectively offsetting the remittance. The IRS observed that these factors allowed taxpayers "to recognize foreign currency loss prematurely."

D. 2016 Regulations

To address these concerns, the IRS issued the 2006 Proposed Regulations that were later finalized as the 2016 Regulations. These regulations set forth a different approach to section 987 that was described in the Preamble to the 2006 Proposed Regulations as the "foreign exchange exposure pool" method ("***FEEP***").

1. Tightening of section 987 gain or loss

To address the fundamental concern with the "base" of assets that give rise to unrealized section 987 gain or loss, the 2016 Regulations classify each asset (and liability) on a QBU's balance sheet as either a "***marked item***" or an "***historic item***." Marked items are assets or liabilities denominated in the functional currency of the QBU and that are perceived to change in value based on changes in exchange rates. Marked items are largely limited to assets or liabilities that if held (or entered into) by the owner directly would constitute section 988 transactions – foreign currency, debt assets or liabilities denominated in a foreign currency, and derivatives of foreign currency or foreign currency denominated debt.[26] Historic items are assets and liabilities that are not marked items and thus include capital assets, section 1231 property, inventory and all other items of non-currency property.[27] The Preamble to the 2006 Proposed Regulations explains that the IRS views historic items as assets (or liabilities) whose value measured in dollars does not change as dollar-functional currency exchange rates change, even where the historic item is immobilized in a non-dollar economic environment.[28]

[26] 2006 Prop. Treas. Reg. § 1.987-1(d).
[27] 2006 Prop. Treas. Reg. § 1.987-1(e).
[28] 71 Fed. Reg. 52876 *supra* note 25 at 52882.

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To ensure that historic items do not contribute to unrealized section 987 gain or loss, the 2016 Regulations require the taxpayer to tax account for the historic item as if it had a dollar basis, effectively excluding it from the "base" of items that give rise to unrealized section 987 gain or loss. As is explained in more detail below, this is accomplished by tracking the historic item's basis in the functional currency of the QBU but, whenever the basis of the item is relevant, the functional currency of the item must be translated back into dollars at the "historic rate" for the item. The historic rate is the exchange rate at the time the item was acquired. Most historic items are assets and, although they are referred to in the regulations as "historic assets" or "historic items," it is slightly more descriptive to refer to them as "***historic-rate assets***" because they are assets whose basis is determined by reference to an historic exchange rate.

The 2016 Regulations also directly address the IRS's earlier articulated concerns with the timing of section 987 gain or loss recognition. Most directly, the regulations tightened the definition of "remittance." Under the 1991 Proposed Regulations, there was no requirement that near-in-time contributions and remittances be netted. Thus, it was possible (as was noted in the Preamble to the 2006 Proposed Regulations)[29] for taxpayers to selectively realize and recognize section 987 gain or loss by remitting an asset and, shortly thereafter, recontributing it. The 2016 Regulations largely prevent this by requiring all transfers to and from the QBU over a calendar year to be netted in order to determine whether there has been a remittance for the year.[30]

A second, less obvious timing rule in the 2016 Regulations is its treatment of stock in lower-tier entities, partnership interests, and borrowings associated with these assets. Under the 1991 Proposed Regulations, these items were on the QBU's balance sheet and therefore, when transferred to the owner, constituted remittances, triggering section 987 gain or loss recognition.

[29] 2006 Proposed Regulations at 43.

[30] Treas. Reg. § 1.987-5(c)(1).

Because these items are rarely if ever integral to the QBU's trade or business, they could be transferred from the QBU to the owner without fundamentally altering the trade or business. Under the 2016 Regulations, these items are excluded from the balance sheet of the QBU, regardless of whether they are reflected on the non-tax books and records of the QBU.[31] The therefore cannot be transferred in a manner that triggers the recognition of section 987 gain or loss.

The practical effect of these two rules is that under the 2016 Regulations, it is much more difficult to trigger the realization and recognition of section 987 gain or loss without fundamentally altering the investment in the QBU's business. In order to trigger realization and recognition, an owner needs to truly contract its net investment in the assets and liabilities that are used in the QBU's trade or business for a meaningful period of time.

2. Determining taxable income arising from the QBU activities

The 2016 Regulations provide generally that the owner's taxable income arising from the QBU's activities is to be determined in the QBU's functional currency and then translated into the owner's functional currency.[32] The default exchange rate used for translating taxable income is the yearly average exchange rate.[33] This general rule directly follows and therefore is consistent with section 987(1) and (2).

Significantly, the 2016 Regulations contain an exception to this general rule for historic-rate assets that largely undercuts the rule. The regulations require that any tax item arising from an historic-rate asset that involves basis recovery be determined by reference to the asset's "historic" exchange rate, rather than the exchange rate used for all other items of QBU taxable

[31] Treas. Reg. § 1.987-2(b)(2).
[32] Treas. Reg. § 1.987-3(b).
[33] Treas. Reg. § 1.987-3(c)(1).

income.[34] The practical effect is that historic-rate assets are tax accounted for on a dollar, rather than a functional currency basis. Thus, in order to determine depreciation, depletion, or amortization deductions with respect to historic-rate assets, one cannot start from the non-tax amounts of these expenses reflected in the QBU's functional currency profit and loss statement. These amounts must be determined first in dollars and then translated back into the QBU's functional currency at the specific asset's unique historic rate.[35] Similarly, in order to determine realized gain or loss with respect to the sale or exchange of an historic-rate asset, it is usually necessary to reverse out the realized gain or loss determined at the QBU level in the QBU's functional currency and then to redetermine the realized gain or loss in dollars. In other words, for purpose of basis recovery including gain or loss realization, it is as if the historic-rate asset were held directly by the owner and not part of the QBU. (Revenue, such as rent, from an historic-rate asset is determined in the QBU's functional currency, is included in overall QBU taxable income determined in functional currency, and is then translated into dollars.)

The treatment of historic-rate assets is most complex in the case of sales or exchanges. In order to determine gain or loss, the amount realized and basis must be determined. The amount realized is initially determined in the QBU's functional currency and then translated into dollars at the current-year average exchange rate.[36] The historic-rate asset's basis, as mentioned above, is its functional currency basis as reflected on the books of the QBU, translated into dollars at the asset's unique historic rate – effectively the same dollar basis it would have had had the owner

[34] Treas. Reg. § 1.987-3(c)(2).

[35] Treas. Reg. § 1.987-3(c)(2)(i).

[36] Treas. Reg. § 1.987-3(e) (Example 7). The rule for translating the QBU's "amount realized" upon a realization event with respect to an historic assets must be inferred from the example. The example cites Treas. Reg. § 1.987-1(c)(3)(i) as governing but that section applies only to "items of income, gain, deduction, or loss" and amount realized is not within this list. Amount realized, of course, is used to compute gain or loss but the example and the mandate to translate basis at the historic rate in Treas. Reg. § 1.987-3(c)(2)(i) make clear that gain or loss with respect to historic assets must be computed in dollars, not the functional currency of the QBU.

held the asset directly.[37] Thus, for purposes of amount realized one exchange rate is used (the current-year average exchange rate) and for purposes of basis determination a different exchange rate is used (the historic rate for the asset). In some situations the historic rate for the assets is itself the current-year average exchange rate. In these cases, the amount realized and basis would not need to be separately translated into dollars because they both would be translated at the same rate. The most common of these cases is where the historic-rate asset is acquired and sold in the same tax year.[38] In most historic-rate asset sale cases, however, such a short cut is not possible. Where the QBU's holding period spans taxable years such that the amount realized and basis each need to be translated at different rates, it is necessary to translate them to dollars in order to determine dollar gain or loss. There simply is no other way to back into the same dollar amount of gain or loss.

In sum, the taxable income from the QBU is generally determined in the QBU's functional currency and then translated into dollars. The large exception to this general rule is the treatment of basis recovery with respect to historic-rate assets. Tax items that arise from basis recovery (depreciation, depletion, amortization, and gain or loss from sale or disposition) are effectively determined in dollars, not the QBU's functional currency.

3. Determining section 987 gain or loss

The 2016 Regulations measure unrealized section 987 gain or loss only with respect to marked assets (and liabilities) – that is, those items that would be section 988 transactions of the owner if held by the owner directly. The unrealized section 987 gain or loss at any time is the

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[37] Treas. Reg. § 1.987-3(c)(2)(i).

[38] This assumes a spot rate election has not been made.

unrealized section 987 gain or loss carried into the year adjusted for changes in the amount of marked assets and liabilities on the balance sheet throughout the year.[39]

As in the case of the 1991 Proposed Regulations, the 2016 Regulations "time" the realization and recognition of section 987 gain or loss by reference to remittances. Specifically, a remittance (determined on the last day of a taxable year) triggers a portion (a percentage between zero and 100%) of the unrealized section 987 gain or loss on that date.[40] The percentage is ratio of the amount of the remittance and the aggregate adjusted basis of the QBU's gross assets (both determined as of the last day of the taxable year). Thus, if the remittance constitutes 25% of the QBU's tax basis balance sheet, it triggers realization and recognition of 25% of the unrealized section 987 gain or loss. For this purpose, the tax basis balance sheet is determined in dollars (not the QBU's functional currency) where marked assets and liabilities are translated at the spot rate on the last day of the year and historic-rate assets are translated at the historic rate (effectively their original dollar basis).

III. Discussion

A. The 2016 Regulations

To frame the discussion of possible alternatives to the 2016 Regulations it is helpful to consider how the treatment of historic-rate assets contributes to complexity/administrative burden, meshes with the statutory framework, and in some cases drives demonstrably uneconomic results.

1. Complexity; administrative burden

Nearly all of the complexity of the 2016 Regulations arises from the treatment of historic-rate assets. Although the 2016 Regulations formally treat historic-rate assets as belonging on the

[39] Treas. Reg. § 1.987-4(d).
[40] Treas. Reg. § 1.987-5(a).

books of the QBU, the 2016 Regulations effectively require the historic-rate assets to be tax accounted for as if they were held directly by the owner outside of the QBU. This separate treatment introduces significant complexity, thereby undermining the administrative efficiency of using the QBU's functional currency profit and loss statement as the starting point for determining taxable income. In our 2008 Report we observed:

> [W]e believe that the treatment of historic assets imposes significant compliance burdens on taxpayers, and we doubt that the requirements can always be satisfied. We do not believe that this burden is significantly reduced for all taxpayers even if . . . the class of marked items is expanded. For example, a financial institution with mostly financial assets may have fewer historic items than a branch operation that manufactures abroad, but both must maintain a complex system for keeping records.[41]
>
> The complexity of the Proposed Regulations stems from translating the year-end balance sheet of the section 987 QBU on an asset-by-asset basis, using for each marked item the spot rate at year end and for each historic item the historic rate. Because all marked items are translated by reference to the same rate, they can easily be pooled, and the net aggregate bases of marked items can be translated using the year-end spot rate. Crucially, however, historic assets and liabilities cannot be pooled under the foreign exchange exposure pool method of the Proposed Regulations, because the exchange rate used for translation depends on each historic item.[42]

2. *Consistency with the statute and legislative history*

The treatment of historic-rate assets does not appear consistent with the statutory text and legislative history. As we stated in our 2008 Report,

> We do not believe that this method of determining the income or loss of a QBU is consistent with section 987 and its legislative history. We believe that section 987(1) and (2) and the discussions in the legislative history require that first the income or loss of a section 987 QBU be determined <u>exclusively</u> in the QBU's functional currency, and then the net amount be translated using the average exchange rate. The language is relevantly similar to

[41] 2008 Report at 38.

[42] 2008 Report at 51-52.

> section 986(b), which governs the translation of earnings and profits of a CFC. Section 986(b) likewise requires the determination of earnings and profits of the CFC in the CFC's functional currency and the translation into U.S. dollars based on the average exchange rate.
>
> The legislative history likewise refers to the "profit and loss method" for determining the income of a section 987 QBU, i.e., that "the taxable income or loss [is determined] separately for each [qualified business] unit in its functional currency." What was new in the subchapter J approach to the profit and loss method was that the determination is to be made by reference to the average exchange rate (and not the spot rate at year end). But the available authorities . . . unequivocally reflect that the profit and loss "method is applied to the <u>collective</u> results of the branch's operations." Under this method, "the net profit [or loss] of the branch is first computed in foreign currency" and only then translated into the taxpayer's currency.
>
> The profit and loss method is also consistent with the manner in which a foreign branch operation would calculate its income in its own functional currency under foreign law and for accounting purposes. We believe that this is the right method. As long as an asset is part of a section 987 QBU, all calculations in respect of the asset should be made in the functional currency of the QBU and without regard to historic exchange rates. Any income and loss calculations for the section 987 QBU that employ a mix of different exchange rates will necessarily reflect these differences. But these differences in turn reflect fluctuations in exchange rates from the perspective of the QBU. Thus, determinations using different exchange rates necessarily conflate exchange gain or loss with branch income or loss.
>
> We therefore believe that the profit and loss method would be the correct and better method. This method is in our view mandated by the clear language of section 987(1) and (2) and the legislative history, and is the better method because it is administratively less burdensome on taxpayers.[43]

3. *Uneconomic section 987 gain or loss*

A third problem with the treatment of historic-rate assets it that they often drive tax results that appear quite detached from the associated economic results. Consider a taxpayer that

[43] 2008 Report at 45-46, citations omitted and emphasis added.

has a net investment in a trade or business that is expected to generate a foreign currency-denominated profit stream. All things being equal, the dollar value of the net investment will increase as the foreign currency strengthens (appreciates against the dollar) and decrease as the foreign currency weakens (depreciates against the dollar). Economically, the investment is said to be "long" the foreign currency. One would expect that the economic increase in value would be reflected in an increase in unrealized section 987 gain mirroring the observed economic and financial statement gain. Indeed, this is precisely the financial statement presentation. For tax purposes, however, where the QBU's balance sheet reflects gross historic-rate assets and gross marked liabilities, the exact opposite is true – the strengthening of the QBU's functional currency creates unrealized section 987 loss, not gain. Similarly, a weakening of the QBU's functional currency against the dollar results in unrealized section 987 gain, not loss.

This counterintuitive tax result is a direct function of the treatment of historic-rate assets. In particular, it is a function of the assumption that only marked assets and liabilities are sensitive to exchange rate movements.[44] This assumption is rarely true for assets whose value in inextricably tied to an expected foreign currency profit stream.[45] A net investment in a business that has no practical choice but to use the assets and liabilities that comprise its balance sheet to earn profits denominated in a currency other than the dollar, is, from the perspective of a dollar owner, sensitive to exchange rate movements even if the particular assets that comprise the business could, under different circumstances be used to generate profits in a different currency.

Consider for example a U.K. QBU that is capitalized by its dollar owner with $2,000. Assume that the QBU immediately converts the $2,000 into £1,500 (reflecting a $1:£0.75

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[44] In the Preamble to the 2006 Proposed Regulations, the IRS and Treasury noted that they "believe that section 988 identifies those items property treated as giving rise to exchange gain or loss for purposes of section 987." 71 Fed. Reg. 52876 *supra* note 7, at 52882.

[45] This assumption could be true for an asset that could be repurposed to generate revenue in a different currency environment.

exchange rate) and then borrows from a third party an additional £3,500. At this point the QBU spends the £5,000 on property that is reasonably expected to generate a pounds sterling profit stream.[46] As an economic matter, the owner has net equity in the QBU of $2,000/£1,500. If nothing happens except that the pound appreciates against the dollar, the business would be more valuable to the owner.[47] This is because the anticipated pound denominated profit stream will, by definition, be worth more dollars as a result of the change in exchange rates. For example, if the pound appreciated 20% against the dollar (while the value of the net equity remained £1,500), the QBU could sell the business, realizing £1,500 pounds. The QBU could then distribute these to the owner who could convert then at the now-higher spot rate into $2,400 – 20% more dollars than the owner originally invested. As an economic matter, the owner would have a $400 profit on the original $2,000 investment, attributable entirely to the favorable exchange rate movement.

	Initial		After 20% appreciation in pound		
	Pounds	USD Value $1 = £0.75	Pound Value	USD Value $1 = £ 0.625	Change in USD Val
Historic Asset	5,000	6,667	5,000	8,000	1,333
Marked Liability	(3,500)	(4,667)	(3,500)	(5,600)	(933)
Net Equity	1,500	2,000	1,500	2,400	400

Under the 2016 Regulations, the owner has the same $400 profit but it is reflected in a counterintuitive way. Under the 2016 Regulations, the change in dollar value of the £3,500 marked liability would be reflected as an unrealized section 987 loss of $933. There would also

[46] The exact nature of the asset does not matter so long as it is one that is reasonably expected to generate a pounds sterling profit stream and cannot be easily repurposed to produce a profit stream in a different currency. Examples could include real estate or plant property and equipment used to produce goods that will be sold in the U.K.

[47] From the perspective of a person who measures wealth in pounds (such as the QBU itself), the change in dollar-pound exchange rates does not impact the value of the business. The value of the expected pound-denominated stream of profits do not change.

be unrealized gain in the historic-rate asset of $1,333.[48] Thus, the net tax gain would be the same $400 observed as the economic gain ($1,333 less $933). If the assets are sold and the proceeds distributed, the gain in the historic-rate asset and the unrealized section 987 loss would both be recognized so that there would be $400 of gain. If the business were not sold, the QBU could borrow cash and transfer the proceeds of the borrowing to the owner, effecting a remittance (reduction in net investment). The remittance would trigger a portion of the unrealized section 987 loss even though as an economic matter there is really only a net economic gain due to currency movements. This result is undesirable as a policy matter.

B. Alternative Method Patterned on the 1991 Proposed Regulations

The most straightforward way to reduce complexity and administrative burden would be for the Treasury and IRS to allow taxpayers to apply the method described in the 1991 Proposed Regulations with certain adjustments that are already reflected in the 2016 Regulations.

Specifically, we recommend allowing taxpayers to compute the QBU's taxable income by reference to the non-tax profit and loss statement of the QBU, backing out only items arising from assets or liabilities that are not part of the section 987 QBU as defined the 2016 Regulations. Thus, to the extent the QBU's profit and loss statement reflects items from its investment in non-portfolio stock, partnership interests (and liabilities properly associated therewith), these items would need to be removed and taken into account separately by the owner. The owner would then simply translate the taxable income determined in the functional currency by applying the existing rules for determining exchange rates (the yearly average

[48] The unrealized gain in the historic asset is the excess of its current value over its basis. Its current value is the same £5,000 pounds for which it was purchased. Converted into dollars at the new 20% higher spot rate dollar value is now $8,000 – 20% higher than its original dollar value of $6,667 (£5,000 converted at original exchange rate). Its basis is the £5,000 functional currency basis, converted at the original (historic) exchange rate and therefore is $6,667. Thus, the recognized gain in the historic asset is $1,333 ($8,000 value less $6,667 basis).

exchange rate or spot rate).[49] This approach is simple, administrable, and entirely consistent with the statute.

With respect to determining unrealized section 987 gain or loss, we recommend allowing taxpayers to use "pool" approach under the 1991 Proposed Regulations. Under this approach, the owner would maintain a dollar basis pool and a functional currency equity pool consistent with the way they were required to be maintained under the 1991 Proposed Regulations. The only material difference is that the new alternative method should remove the flexibility in the determination of a netting convention allowed in the 1991 Proposed Regulations[50] and incorporate the annual netting concept to determine remittances such that there is only one net remittance a year.

Finally, under this alternative approach, a net remittance for the year would trigger the recognition of section 987 gain or loss. Specifically, the owner would determine the percentage to be triggered by computing the ratio of the QBU's functional currency adjusted basis of the property remitted to the amount of the equity pool immediately before the remittance – again, consistent with the 1991 Proposed Regulations. Realized and recognized losses under this approach could be subject to an additional deferral regime, discussed below.

This approach would be far less complex and therefore far more administrable than the current approach. It has the added benefit of being more closely aligned with the statutory structure and legislative intent.

C. Earnings-only

Other alternative methods are possible as well. One approach currently used by some is to apply the profit and loss method for determining the taxable income of the QBU but then to

[49] Treas. Reg. § 1.987-1(c).
[50] *See* 1991 Prop. Treas. Reg. § 1.987-2(b)(2)(i).

track unrealized section 987 gain or loss with respect to unremitted earnings only. Specifically, the dollar basis and functional currency equity pools would be increased only for earnings. Remittances would be allocated between earnings and capital (either first to earnings until all earnings remitted or pro-rata between earnings and capital). Remittances would trigger realization and recognition of a portion of the unrealized section 987 gain loss in the same manner as the base approach (subject to a potential loss deferral rule discussed below). Although an earnings-only method is less economically accurate than a net-investment method described above, it is easier to administer than the approach of the current regulations. Moreover, the 2006 Proposed Regulations specifically determined that "earnings only" would be considered a "reasonable method" for purposes of the then-proposed transition rule.[51]

D. Deferral of Losses Attributable to Remittances

We understand that the IRS is considering exercising its authority under section 989(c)(2) to provide rules that limit the ability of taxpayers to taken into account section 987 loss that would otherwise be recognized upon a remittance. The IRS's concern with remittance-based loss recognition was discussed in both Notice 2000-20 and the Preamble to the 2006 Proposed Regulations.

It is not clear that a loss deferral overlay is necessary, especially for taxpayers who would elect the alternative method we recommend. It is worth noting that the ability to selectively trigger realization of section 987 loss (without fundamentally altering the owner's net investment in the QBU) has been constrained by several features of the 2016 Regulations. In particular, the removal of non-portfolio stock, partnership interests, and liabilities associated therewith eliminates a significant item from the balance sheet of the QBU that, because it is not core to the business activities of the QBU, be transferred to the owner without fundamentally altering the

[51] 71 Fed. Reg. 52876 *supra* note 7 at 52890; 2006 Prop. Treas. Reg. § 1.987-10(d) (Example 2).

business. Second, the requirement to determine whether there is a remittance on an annual basis significantly limits the ability to temporarily remit property. Consideration should be given as to whether these two provisions are a sufficient response. Stated another way, remittances are not tax elections. In order to have a remittance, especially after the changes described above, it is necessary to contract the owner's net investment in the QBU through a distribution of property. To access the tax loss it is necessary to change the composition of the non-tax balance sheet or, viewed from a different perspective, only real changes to the composition of the balance sheet can trigger then current recognition of tax loss.

Another consideration relevant when weighting the cost-benefit of a loss deferral rule is the economic (or uneconomic) nature of the loss. Under the alternative approach we discuss above, unrealized section 987 losses will correlate to real economic losses.[52] It is not clear that accessing a loss of this type especially through a transaction (the remittance) that economically contracts the net balance sheet of a business is an unwarranted result. Losses are often countenanced where a taxpayer partially liquidates an investment position. In general, a sale of some, but not all, of a block of stock, each share of which has identical basis, results in a proportionate amount of loss recognition. Arguably, a remittance that reduces the owner's net investment in an underwater position (the depreciated QBU) ought to be treated similarly.

If a remittance loss deferral regime is proposed, we recommend that it "overlay" the remittance concept of the regulations. In other words, the rules would provide that remittances trigger recognition of section 987 gain or loss and, to the extent the item is a loss, it would be

[52] The appropriateness of a loss deferral rule may very well be different for taxpayers, if any, who end up applying the 2016 Regulations. As discussed above, where the QBU's balance sheet consists of historic assets and net marked liabilities, there will be unrealized section 987 loss when there is, economically, a net gain due to the strengthening of the QBU's functional currency against the dollar. Allowing a taxpayer to recognize the loss here without simultaneously recognizing the more-than-offsetting unrealized gain in the historic asset is much more difficult to justify as a policy matter.

taken into account only if it were not deferred under the loss deferral rule. We can envision three possible rules: (1) a rule that works symmetrically by deferring both gain and loss until the QBU is terminated or otherwise disposed of, (2) a "loss carryforward" rule where realized loss is deferred until a future period in which there is realized gain arising from the same QBU, or (3) a "loss lookback" rule where realized loss is allowed in the current period to the extent it does not exceed prior period realized section 987 gains from the same QBU.

Of these, we recommend the look-back approach. It is consistent with the treatment of "net negative adjustments" with respect to contingent payment debt instruments.[53] Under those rules, as contingencies on a contingent payment debt instrument resolve, the holder adjusts its interest income.[54] If the contingency resolves for an amount less than that originally projected, the holder has a "negative adjustment" – essentially negative interest income. The negative adjustment offsets current-year interest inclusions from the debt and if it is greater than the aggregate current year inclusions, it results in a "net negative adjustment." The net negative adjustment is allowed as current ordinary loss to the extent of prior net interest income inclusions from the same debt instrument.[55]

E. Transition Rule

Notice 2017-57 specifically requires comments on "alternative" transition regimes. For the reasons explained below, we recommend that the existing transition regimes be replaced with a single new regime.

The 2006 Proposed Regulations proposed two alternative transition rules – the "deferral" method" and the "fresh start" method. Under the deferral method, immediately before the

[53] Treas. Reg. § 1.1275-4.
[54] Treas. Reg. § 1.1275-4(b)(6).
[55] Treas. Reg. § 1.1275-4(b)(6)(iii).

transition date, all QBUs would be deemed to terminate for purposes of measuring unrealized section 987 gain or loss on a QBU-by-QBU basis as of the transition date. The section 987 gain or loss so determined was then treated as net unrecognized section 987 gain or loss of the new QBU beginning immediately after the transition date. To ensure that lifetime income was not duplicated or omitted, the deferral rule then required the "historic rate" to be set in a manner that preserved the date-of transition unrecognized gain or loss in the asset. In other words, the dollar basis of the asset was to be set such that the unrealized economic gain or loss with respect to the asset equaled the sum of (1) the portion of unrealized section 987 gain or loss attributable to the asset and (2) unrealized gain or loss reflected in the dollar basis of the asset.

The fresh start method, by contrast, was both more straightforward and less economically accurate. Under this method, the unrealized section 987 gain or loss as of the date of termination was ignored. The taxpayer would start each new QBU with no beginning unrealized section 987 gain or loss. In addition, the taxpayer would translate asset basis (and liability amount) at the historic exchange rate for the date the asset was acquired (or the liability) was entered into. This method, by definition, results in items of economic gain or loss being permanently omitted. For example, consider a QBU (applying the 1991 Proposed Regulations) that acquired an asset at the time the QBU was formed. If the dollar strengthens against the QBU's functional currency, the unrealized section 987 item attributable to the asset would be a loss. If the fresh start transition were applied while that asset were still on hand, no items would be permanently lost. The unrealized section 987 loss attributable to that asset (indeed attributable to all assets) would disappear. Significantly, the requirement that the new QBU determine its initial basis by reference to historic exchange rate at the time that asset were acquired would effectively restore the loss.[56] If the original asset had been sold after the strengthening of the dollar and a new asset acquired with the proceeds, the unrealized section 987 loss eliminated upon the fresh start would only be restored to the extent it was drive by a strengthening of the dollar after its acquisition. The portion of the unrealized section 987 loss attributable to the strengthening of the dollar while the original asset was on hand was forever lost.

The 2016 Regulations jettisoned the deferral regime, making the fresh start rule the exclusive rule. The practical effect, especially given the dollar's strengthening against many currencies of the world, for many taxpayers is that economically experiences losses would be permanently disallowed. This type of permanent disallowance without specific congressional authorization is an undue financial burden.[57]

We believe that there should be a single transition rule and that it should preserve lifetime taxable income. The most straightforward way of implementing would be to provide that on the transition date, the unrealized section 987 gain or loss from the old method must be carried over as unrealized section 987 gain or loss under the new method. In addition, depending on the precise type of transition, adjustments to asset basis might be necessary to ensure there are no duplications or omissions of lifetime taxable income.

F. Section 351 Transfer of a QBU

The 2016 Regulations treat the transfer of a QBU in a transaction to which section 351 applies as a termination, triggering the realization and recognition of section 987 gain or loss immediately before the section 351 transaction.[58] In situations where (i) the transferor and

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[56] For this purpose, it does not matter whether the asset was an historic item or a marked item.

[57] Whether the 2016 Regulations impose or result in an "undue financial burden" is one of the criteria under which the 2016 Regulations are being evaluated. *See* Notice 2017-38, 2017-30 I.R.B. 147.

[58] Treas. Reg. § 1.987-8(b)(2). *See also* Treas. Reg. § 1.987-2(c)(2)(ii)(transfer of QBU assets and/or liabilities for non-QBU assets, such as stock in transferee corporation, results in a deemed termination event immediately before and therefore section 351 does not apply.)

transferee are members of the same controlled group), (ii) the transferee corporation has the same functional currency as the transferor, and (iii) the transferee reflects the assets and liabilities transferred as part of its own QBU (a “successor QBU”), the transferor’s realized section 987 gain or loss is deferred.[59] This deferred gain or loss is taken into account by the transferor as remittances are made out of the transferee’s successor QBU.[60] The practical effect where this rule applies is to ensure that the transferor will eventually recognize the section 987 gain or loss as section 987 gain or loss at the same time and in the same manner as would be the case if the transferee and transferor were divisions of a single corporation. The rule is modeled on those for intercompany transactions as well as those for loss recognition upon sales between taxpayers bearing a section 267(f) relationship.

In our 2008 Report we commented that, absent a compelling policy reason such as preventing the importation of loss, unrealized section 987 gain or loss should be treated in the same manner as any other item of built-in gain or loss.[61] We remain of this view and therefore renew our recommendation that, in the case of a contribution of a QBU in a section 351 transaction, the transferor should be entitled to non-recognition treatment for unrealized section 987 gain or loss to the same extent that it is entitled to non-recognition treatment for other items of unrealized gain or loss reflected in the difference between asset basis and fair market value.

[59] Treas. Reg. § 1.987-12T(b).

[60] Treas. Reg. § 1.987-12T(c)(1).

[61] 2008 Report at 63.