NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS UNDER SECTION 987

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Report No. 1140

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UNDER SECTION 987[1]

This report comments on the proposed regulations issued on September 7, 2006 under section 987 (the "Proposed Regulations") of the Internal Revenue Code of 1986, as amended (the "Code"),[2] regarding the determination of income or loss of a qualified business unit of a taxpayer that has a functional currency different from its taxpayer (a "section 987 QBU") and the recognition of foreign currency exchange gain or loss in respect of such a qualified business unit.[3] At the same time, proposed regulations under section 987 from 1991 (the "1991 Proposed Regulations")[4] were withdrawn.

We believe that the Proposed Regulations create a well thought out and coherent structure designed to bring consistency and order to an exceedingly complex area. We commend the Treasury and the Internal Revenue Service ("IRS" or "Service") for an impressive effort. We do have certain suggestions, which are set out below. These range from comments that address the general approach, which we believe will be difficult for taxpayers to comply with, to comments on certain topics identified in the Preamble as of interest to Treasury and the IRS.

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1 The principal drafters of this report were Peter Blessing and Ansgar Simon. Helpful comments were received from Micah Bloomfield, Neil Feinstein, Patrick Gallagher, Paul Housey, David Miller, and Yaron Reich.

2 Unless otherwise indicated, all "section" references are to the Code.

3 REG-208270-86, 71 Fed. Reg. 52876 (Sept. 7, 2006), corrected 71 Fed. Reg. 77654 (Dec. 27, 2006).

4 INTL-965-86, 56 Fed. Reg. 48457 (Sept. 25, 1991).

I. SUMMARY OF RECOMMENDATIONS

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

1. We believe that the "foreign exchange exposure pool method" as implemented by the Proposed Regulations would create an excessive record keeping burden, that many businesses may not be able to comply with the requirement to track, for each "historic asset," the spot exchange rate as of the date the section 987 QBU acquired the asset, and that the hybrid "separate transaction" aspect of the foreign exchange exposure pool method has additional shortcomings. In particular:

   a. We believe that, and propose a framework as to how, the section 987 QBU's taxable income should be determined under the "profit and loss method." We believe that the profit and loss method is administratively easier to implement than the hybrid "separate transaction method" of the Proposed Regulations, more accurately measures a section 987 QBU's income or loss in the currency of its economic environment, and is required under section 987 and its legislative history.

   b. We believe that the determination of "net unrecognized section 987 gain or loss" under the foreign exchange exposure pool method could be simplified by pooling the adjusted bases of historic assets and either pooling or tracing historic liabilities (or treating all liabilities as marked items), and we propose a framework for doing so.

2. We agree with Treasury and the Service that taxpayers should not be able to manipulate the timing of their recognition by a section 987 QBU of gain or loss derived from fluctuations of foreign currency exchange rates. We therefore believe that, as a general guideline, "remittances" and "contributions" should be limited to situations in which assets or

liabilities clearly move from a section 987 QBU back to its owner or *vice versa*. More specifically, we:

a. commend that the net amount transferred between a section 987 QBU and its owner is determined on an annual basis, rather than by daily netting as under the 1991 Proposed Regulations;

b. commend that a taxpayer may group several eligible QBUs with the same functional currency into a single section 987 QBU, because it reduces the number of transfers between QBUs that can trigger recognition of section 987 gain or loss;

c. recommend that grouping also be allowed for eligible QBUs that are held directly by the taxpayer (*e.g.*, in the form of a branch) with those held indirectly through "section 987 partnerships;"

d. recommend that a taxpayer be required to group into a single section 987 QBU (i) a QBU that arises in respect of a non-portfolio interest of a taxpayer and has a different functional currency with (ii) a QBU that holds the non-portfolio interest (but for certain attribution rules of the Proposed Regulations) and has the same functional currency;

e. recommend that a consolidated group be treated as a single taxpayer and therefore be permitted to elect grouping of all eligible QBUs (with the same functional currency) of members of a consolidated group, subject to the recommendations above;

f. recommend that reorganizations, liquidations and section 351 contributions to controlled corporations that are otherwise tax-free under the Code and the Treasury regulations (taking into account section 367) not be treated as "terminations" of a section 987 QBU in which the unrecognized section 987 gain or loss

is triggered, unless the transferee corporation has the same functional currency as the section 987 QBU and, possibly, except if the section 987 QBU has unrecognized section 987 loss; and

g. recommend that a section 987 QBU of a foreign corporation that is a controlled foreign corporation within the meaning of section 957(a) (a "CFC") not be treated as terminating when it ceases to be a CFC.

3. We agree with Treasury and the Service that the source, character and category for purposes of sections 904 and 954 of section 987 gain or loss is determined by reference to the underlying income that gave rise to the gain or loss. We believe, however, that the average tax book asset method may in many cases not provide a good proxy for post-1986 earnings, and therefore recommend to use the latter, as is required under section 987(3)(B).

4. We commend Treasury and the Service for proposing rules governing section 987 for partnership interests. We believe, however, that the aggregate treatment of partnerships for purposes of section 987 creates considerable compliance problems and certain anomalies that would not occur if section 987 gain or loss were treated as a partnership item. We therefore suggest that partnerships generally be treated as entities that determine their section 987 gain or loss as partnership items, except that any partner that owns an interest in the partnership representing at least 10% (or, e.g., 25%) of the total interests in partnership capital or profits may elect aggregate treatment for its interest in the partnership for section 987 purposes (which election would permit it to group its partnership QBU as recommended above).

5. We believe that S-corporations should be treated like other corporations and that section 987 gain or loss should be recognized by the S-corporation and allocated to its shareholders in the same manner as other items of income of the S-corporation.

6. We recommend that in the case of a QBU of an estate or trust that has a different functional currency from the estate or trust, the estate or trust, and not the beneficiaries, be treated as the owners of a section 987 QBU.

7. We believe that the Proposed Regulations in their current form could not be implemented by bank branches, whose transactions with the parent and with sister branches are too numerous to track historic assets properly. We therefore recommend that, even if not adopted more generally, an expanded definition of "marked item," which would include all financial assets, be used in the case of banks, which should alleviate the compliance problems.

8. We commend the recent issuance of Notice 2007-42,[5] pursuant to which section 987 gain or loss is treated as income that qualifies under section 856(c)(2) and (3) to the extent of the underlying income that gave rise to the section 987 gain or loss. We recommend that, in addition to this character rule, in applying section 987 to REITs, a section 987 QBU treat all of its real estate assets as marked assets.

9. We suggest that consideration be given to whether the fresh start method should be the only available transition method for taxpayers.

II. BACKGROUND

As part of the Tax Reform Act of 1986 (the "TRA"),[6] Congress added subpart J to the Code, which adopted the "functional currency" concept and provided a detailed set of rules regarding transactions in a currency other than the functional currency of a taxpayer. Specifically, subpart J contains two methods of accounting for such transactions. Transactions of a "qualified business unit" of the taxpayer that has a different functional currency than the taxpayer are subject to the "profit and loss method" of section 987. By contrast, non-functional

5 2007-21 I.R.B. 1288.

6 P.L. 99-514, 100 Stat. 2085 (Oct. 22, 1986).

currency transactions that are not attributable to a section 987 QBU are generally accounted for on a transaction-by-transaction basis under section 988. The profit and loss method was intended to reduce complicated accounting procedures that would be required under any method that requires currency translation on a transaction-by-transaction basis.[7] Code section 987 currently states:

> In the case of any taxpayer having 1 or more qualified business units with a functional currency other than the dollar, taxable income of such taxpayer shall be determined—
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> (1) by computing the taxable income or loss separately for each such unit in its functional currency,
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> (2) by translating the income or loss separately computed under paragraph (1) at the appropriate exchange rate, and
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> (3) by making proper adjustments (as prescribed by the Secretary) for transfers of property between qualified business units of the taxpayer having different functional currencies, including
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> (A) treating post-1986 remittances from each such unit as made on a pro rata basis out of post-1986 accumulated earnings, and
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> (B) treating gain or loss determined under this paragraph as ordinary income or loss, respectively, and sourcing such gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.[8]

The "appropriate exchange rate" is for this purpose the average exchange rate for the taxable year of the qualified business unit.[9] A "qualified business unit" (or "QBU") is a "separately and clearly identified unit of a trade or business of a taxpayer which maintains

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7 S. REP. NO. 99-313, at 454, 1986-3 C.B. (vol.3) 454.

8 Section 987 was amended by Section 1012(v)(1)(B) of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, 102 Stat. 3342), which removed the requirement (by cross-reference to pre-1988 section 986(b)) that foreign income taxes paid by a QBU of a taxpayer be translated at the spot exchange rate.

9 Section 989(b)(4).

separate books and records."[10] The Secretary was further specifically authorized to prescribe regulations to (1) limit the recognition of foreign currency loss on remittances from a QBU to its owner, (2) provide appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer), and (3) set forth procedures for determining the average exchange rate of any period.[11]

The important change to pre-1987 law was that section 987 adopted the profit and loss method as the exclusive method for determining a QBU's income or loss and stated that, but did not specify a method for determining how, remittances would give rise to gain or loss on account of foreign currency exchange rate fluctuations.[12]

A. Branch Currency Translations Before the Taxpayer Relief Act of 1986

Before enactment of section 987, the income of a "foreign branch" (of a domestic taxpayer) could be determined on an aggregate basis for the branch under one of two methods, the "profit and loss method" and the "net worth" or "balance sheet" method.

Under the profit and loss method,[13] the foreign branch's profit or loss in U.S. dollars was calculated by translating the profit and loss as determined in the currency in which the branch keeps a separate set of books (i) to the extent of amounts of any profit remitted, at the

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10 Section 989(a). This concept is further elaborated in Treas. Reg. § 1.989(a)-1. Foreign exchange gain or loss determinations are ultimately made by reference to the functional currency of a QBU, which is the codified equivalent of a "branch" as the term was used in the foreign exchange context prior to the TRA.

11 Section 989(c)(2), (5) and (6).

12 It is worth noting that section 987 leaves open whether and how pre-1987 remittances between branches and their owners that were not section 1001 recognition events would give rise to any foreign currency exchange gain or loss.

13 Rev. Rul. 75-107, 1975-1 C.B. 32, obsoleted by Rev. Rul. 2003-99. *Cf.* O.D. 550, 2 C.B. 61 (1920), superseded by Rev. Rul. 75-107. *See also Travelers Ins. Co. v. United States*, 303 F.3d 1373 (Fed. Cir. 2002), *cert. denied*, 124 S.Ct. 101 (2003).

spot rate on the date of remittance and (ii) in respect of non-remitted amounts,[14] at the spot rate on the last day of the taxable year.

Under the net worth method,[15] the U.S. dollar amount of the foreign branch's income or loss was calculated as the difference between the "net worth" of the branch (*i.e.*, the net assets value) as determined at the beginning and the end of the taxpayer's taxable year and translated from the foreign currency used by the foreign branch into U.S. dollars.[16] Remittances from the foreign branch to the domestic taxpayer during the taxable year were for this purpose added back to the year-end balance sheet at the spot rate on the date remitted. In the case of current assets and liabilities (but not non-current assets and liabilities), the net worth method therefore effectively marked-to-market the foreign exchange movements, as though the current assets and liabilities of the branch were liquidated each year.[17]

For purposes of the U.S. dollar translation, the net worth method distinguished between current and non-current assets and liabilities. The U.S. dollar value of current assets and liabilities was calculated at the beginning and the end of each taxable year at the respective spot exchange rate; non-current assets and liabilities by contrast were translated into U.S. dollars at the exchange rate on the date they were acquired or incurred (the "historic exchange rate").

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14 Although we are not aware of any specific examples, this would have included cash in the currency of the branch's owner.

15 Rev. Rul. 75-106, 1975-1 C.B. 31, obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388. *Cf.* Office Decision (O.D.) 489, 2 C.B. 60 (1920), superseded by Rev.Rul. 75-106. *See also Frederick Vietor & Achelis, et al. v. Salt's Textile Mfg. Co.*, 26 F.2d 249 (D.Conn. 1928).

16 Authorities and discussion were limited to the treatment of a U.S. taxpayer using the U.S. dollar that owns a foreign branch, but the method of course applies as well to any branch using a functional currency different than that of its owner.

17 *See* D. R. RAVENSCROFT, TAXATION AND FOREIGN CURRENCY, 274, 288 (Harvard University Press 1973).

Depreciation in the case of non-current assets was likewise calculated at the historic exchange rate applicable to the depreciated asset.[18]

Except for remittances of money that were made out of the profits of the branch during the taxable year and in the foreign currency of the branch,[19] neither method countenanced the recognition of foreign currency gain or loss on the occasion of a remittance. This may not have been necessary under the net worth method because cash remittances were added back to the year-end balance sheet.[20] Arguably, because a transaction between a branch and its owner was in any case not a recognition event, there should have been no further exchange gain or loss recognition under pre-1986 law. No guidance existed, however, on the determination of the U.S. dollar basis on the remittance of any assets from the foreign branch to its U.S. owner. It is the same now for section 367(b) liquidations.[21]

A branch could, of course, choose not to determine branch profits or losses on an aggregate basis but rather determine the income, gain or loss in respect of each transaction separately and in the currency of the branch's owner (the "separate transaction method"). For example, a U.S. corporate owner of a foreign branch would keep records of all transactions of the foreign branch in U.S. dollars. Sales of inventory assets would in that case be no different than sales of inventory by the owner directly. The items that would result in recognition of foreign exchange gains or losses would also be the same as those of the owner, and so would be

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18 *See id.* at 86.

19 It appears that "remittance" was understood to be transfers of foreign currency. *See id.* at, *e.g.*, 188, 257 or 261. Ravenscroft, refers, for example, to "remittances translated at the exchange rate at which the remittance had actually been converted." *Id.* at 86. This is consistent with vernacular usage. *See* Merriam Webster Collegiate Dictionary 11th ed. ("1 a: a sum of money remitted b: an instrument by which money is remitted 2: transmittal of money (as to a distant place)").

20 *See* Ravenscroft, *supra* note 17, at ¶9/6.

21 *See* Treas. Reg. § 1.367(b)-3(b)(3)(iii), which reserves for recognition of exchange gain or loss with respect to capital. For a discussion, see R.L. Doernberg and M. Thompson, *Recognition of Foreign Currency Exchange Gains or Losses on a U.S. Inbound Event*, 28 TAX NOTES INT'L 925 (December 2, 2002).

their timing. It is of course the heightened frequency of such transactions, usually in the currency of the economic environment of the foreign branch, that prompted the need for an accounting method for foreign branches with different currencies than their owners on a branch basis rather than a transactional basis.

B. The Taxpayer Relief Act of 1986

The TRA added section 987, as mentioned above. Sections 987(3)(B) and 989(c)(2) specifically require that foreign exchange gain or loss be recognized on a remittance, but did not specify any method for doing so. It is clear from the legislative history, however, that Congress believed that "remittances" from non-functional currency QBUs of a taxpayer should trigger "gains and losses inherent in functional currency or other property remitted to the home office" in a manner that would generally avoid a different treatment between branch operations and operations conducted through a subsidiary.[22] The House Report states:

> A taxpayer will recognize exchange gain or loss on remittances of branch profits (whether or not actually converted to dollars) to the extent the value of the currency in the year of the remittance differs from the value when earned. Consistent with the treatment of distributions from foreign subsidiaries, the bill provides that remittances of foreign branch earnings (and interbranch transfers involving branches with different functional currencies) after 1985 will be treated as paid pro rata out of post-1985 accumulated earnings of the branch. The committee anticipates that, in general, the value of the currency will be determined by translating the currency at an average exchange rate for the year in which received rather than the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be deemed to be ordinary, and subject to separate limitations.[23]

The Senate Report summarized that

> because the profit and loss method would not translate balance sheet gains and losses, some mechanism for recognizing gains and losses inherent in

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22 H.R. REP. NO. 99-426, at 469f, 1986-3 C.B.(Vol. 2) 469-70.

23 *Id.* at 479-80. (Because of the date of its publication, the House Report referred to 1985, rather than 1986, *i.e.*, the year that the TRA was enacted.)

> functional currency or other property remitted to the home office must be provided. ... One of the reasons for the adoption of the pooling approach is to reverse certain present-law consequences that result in the disparate treatment of branch operations and operations conducted through a subsidiary. Similarly, the committee adopted a pooling approach for purposes of determining exchange gain or loss on branch remittances.
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> ...
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> A taxpayer will recognize exchange gain or loss on remittances (without regard to whether or when the remittances are converted to dollars), to the extent the value of the currency at the time of the remittance differs from the value when earned.[24]

The Conference Report, which generally followed the Senate amendments, clarified that

> (1) any remittance of property (*not just currency*) will trigger exchange gain or loss inherent in accumulated earnings *or branch capital*, and (2) exchange gain or loss on remittances will be sourced or allocated by reference to the income giving rise to post-1986 accumulated earnings (generally, the residence of the qualified business unit, unless the income of the unit is derived from U.S. sources.)[25] (Emphases added).

Although the TRA and its legislative history did not specify any particular methodology for the determination of the amount of gains or losses on remittances, there is no doubt that remittances by the branch to its owner would be recognition events, that the amount of gain should generally be similar to that recognized on a distribution by a subsidiary and that only gains or losses resulting from exchange rate fluctuations should be recognized.

The legislative history of the TRA also makes unequivocally clear that sections 987(1) and (2) effectively disallow the net worth method for calculating branch profit or loss: "the net worth method will no longer be an acceptable method of computing income or loss of a

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24 S. REP. NO. 99-313, at 470, 1986-3 C.B. (Vol. 3) 470.

25 CONF. REP. NO. 99-841 vol II, at II-675, 1986-3 C.B. (Vol. 4) 675.

foreign branch for tax purposes, and only realized exchange gains and losses on branch capital will be reflected in taxable income."[26]

C. The 1991 Proposed Regulations

In 1991, Treasury released the 1991 Proposed Regulations, under which each owner of a QBU with a functional currency different from that of its owner effectively was assigned an outside basis (the "basis pool"), in units of the owner's functional currency, in the QBU, and the QBU was assigned a corresponding inside basis (the "equity pool"), in units of the QBU's functional currency, in all of its assets. Under this "pool method," when the owner transferred an asset to the QBU, the basis pool was increased by the adjusted basis of the transferred asset; this amount, as translated into the QBU's functional currency at the spot rate on the date of transfer, was added to the equity pool of the QBU.[27] Once its owner had transferred an asset to the QBU, the asset's historic adjusted basis in the owner's functional currency was extinguished regardless of the class of asset. A transfer of a liability was for this purpose treated as the inverse of a transfer of an asset.[28] Thus, the equity pool in effect equaled the net aggregate adjusted bases of the QBU's assets (as reduced by the amount of liabilities transferred to the QBU) in the QBU's functional currency.

Profits and losses for each taxable year of the QBU, as determined in the QBU's functional currency, were generally translated into the owner's functional currency based on the average exchange rate for the taxable year (with some exceptions discussed below). The amount of any profit was added to the equity pool (in the QBU's functional currency) and the basis pool

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26 S. REP. NO. 99-313, at 470, 1986-3 C.B. (Vol. 3) 470.

27 1991 Prop. Reg. § 1.987-2(b)(2)(iii).

28 1991 Prop. Reg. § 1.987-2(b)(2)(iv).

(translated into the owner's functional currency). Similarly, losses were subtracted, and the equity pool could, if exchange rates had appropriately changed, become negative.

Any transfer of an asset from the QBU to its owner (or of a liability from the owner to the QBU) was treated as a remittance that triggers section 987 exchange gain or loss, though transfers from owner to QBU and from QBU to owner (including deemed transfers in relation to liabilities) were netted on a daily basis. The adjusted basis of the asset was translated back into the owner's functional currency at the spot rate on the date of remittance, regardless of the class of asset. The section 987 gain (or loss) equaled the difference between this new adjusted basis and the portion of the basis pool attributable to the asset. This portion equaled the fraction of the equity pool represented by the adjusted basis of the remitted asset, as determined in the QBU's functional currency immediately before the transfer. Any such gain or loss was ordinary under the 1991 Proposed Regulations, and its source and character for purposes of section 904(d), 907 and 954 was determined by the method that the owner used to allocate and apportion interest expenses under section 864(e).[29]

To illustrate, assume that on January 1, 1995, DP, which is a calendar year taxpayer with the U.S. dollar as its functional currency, opened branch FB in country X, which was a separate QBU and had £-sterling as its functional currency, by transferring an aircraft with an adjusted basis of $100. At the date of transfer, $100 was worth £65. Thus, the opening basis pool was $100 and the opening equity pool was £65. FB had a net profit of £15 for 1995. The average exchange rate for 1995 was £ 0.6250 for $1. Thus, the basis pool was increased by $24 (*i.e.*, £15 × $1/£0.6250) to $124 and the equity pool to £80. Assume that the depreciation

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[29] 1991 Prop. Reg. §§ 1.987-2(e) and (f). Based on the method used by a taxpayer for the allocation of interest, section 987 gain or loss was thus apportioned, either on the basis of the QBU's gross assets or of its gross income, between U.S. source and foreign source, and to the separate foreign tax credit limitation baskets under section 904.

deduction for the aircraft for 1995 amounted to £32.50, so that its adjusted basis for U.S. tax purposes at the beginning of 1996 was £32.50. On January 1, 1996, when $1 was worth £0.59, the aircraft was transferred back from FB to DP. Thus, DP's adjusted basis in the aircraft equaled $55.08 (*i.e.*, (£65 - £32.50) × $1/£0.59). The portion of the $124 basis pool attributable to the aircraft on January 1, 1996 equaled $50.38—the fraction of the basis pool equal to the fraction that the adjusted basis of the aircraft before the transfer, £32.50, represented of the equity pool of £80, *i.e.*, approximately 40.63% of the basis pool. The excess of the newly determined U.S. dollar adjusted basis of the aircraft over the attributable portion of the basis pool, $4.70, was DP's section 987 gain. Had the £-sterling instead depreciated in value to £0.6915 for $1, DP would have had a U.S. dollar basis of $47.00 in the remitted aircraft and would have recognized a section 987 loss of $3.38 ($50.38 minus $47.00).

The pooling method implemented by the 1991 Proposed Regulations was generally believed to result in distortions because an asset like the aircraft, whose value is not considered to vary with exchange rate fluctuations, could give rise to exchange gain or loss, rather than only transactions potentially subject to section 988 (*e.g.*, cash, indebtedness, currency denominated forward or futures contracts, notional principal contracts, etc.). Treasury and IRS expressed concern about this,[30] particularly in the case of section 987 losses.[31] In other words, under the equity pool method of the 1991 Proposed Regulations, exchange gain and losses could be realized in respect of the entire net branch capital.

The pooling method was also problematic because any remittance of less than all of the QBU's assets would result in a pro rata recognition of the aggregate built-in exchange gain

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30 *See* Notice 2000-20, 2000-1 C.B. 851.

31 *See* Preamble, 71 Fed. Reg. at 52879

or loss of all of the QBU's assets and its earnings and profits.[32] Thus, in the example above, the aircraft on a separate basis would have had a starting adjusted basis of $100/£ 65; depreciation in 1995 of $52/£32.50 using the average exchange rate; and a re-translated adjusted basis of $55 (or $47 in the loss scenario). DP should therefore arguably have had foreign exchange gain in respect of the aircraft (if any at all) of $7 (or a loss of $1).[33] This is, of course, a result of the pooling method in which the unrecognized section 987 gain or loss in respect of all relevant assets of the QBU is pooled and remittances lead to a pro rata recognition.

The 1991 Proposed Regulations also created significant complexity in the view of some commentators by requiring daily netting of transfers between the owner and its QBU.[34] It effectively required the QBU to keep track of its net transfers for each day. Moreover, this rule could be used aggressively by transferring relatively mobile assets at a time when the QBU's functional currency had depreciated relative to the functional currency of its owner and (possibly) re-transferring assets at a later time, as identified by the Service in Notice 2000-20. Such transfers are abusive, according to the Service, because they allow a taxpayer "to recognize foreign currency losses prematurely with respect to purported transfers that do not constitute actual economic remittance."[35]

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32 *Cf.* R. Camacho, M. Lukacs, J. Lysenko and Dmitri Semenov, *Check-the Box Planning: Don't Overlook Broad Net of the Section 987 Branch Transaction Rules*, 11 J. INT'L TAX'N 16 (December 2000).

33 *I.e.*, a retranslated adjusted basis of $55, which exceeds the adjusted basis of $48 ($100-$52) at the end of 1995 by $7. In the loss scenario, the retranslated basis is $47, resulting in a loss of $1.

34 1991 Prop. Reg. § 1.987-2(b)(2)(i). *See e.g.*, R. Camacho et al., *supra* note 32; Letter from P. Daub, J. McDonald and R. Walton dated June 16, 2000, to R. Rosenberg (Associate Chief Counsel (International)), 21 TAX NOTES INT'L 230 (July 17, 2000) Doc 2000-17807. Not all commentators shared this view. *See* Letter from R. Katcher dated August 3, 2000, to R. Rosenberg (Associate Chief Counsel (International)), 21 TAX NOTES INT'L 2022 (Oct. 30, 2000) Doc 2000-26755.

35 *See* Notice 2000-20, III.A., *supra* note 30.

D. The Proposed Regulations

In accordance with section 987, the Proposed Regulations provide (1) new rules for the calculation and timing of recognition of foreign currency exchange gain or loss of the owner in respect of a QBU whose functional currency is different than that of the owner and (2) new accounting methods for the determination of the profit or loss, in the owner's currency, of the owner of such a section 987 QBU. Treasury and the Service labeled these as the "foreign exchange exposure pool method." Like the 1991 Proposed Regulations, unrecognized foreign exchange gains or losses inherent in a section 987 QBU are "pooled" under the foreign exchange exposure pool method and, upon remittance of any assets (or liabilities) from the section 987 QBU to its owner, recognized on a pro rata basis. Unlike the 1991 Proposed Regulations, however, only the subset of assets and liabilities that in the view of the Service give rise to "economic foreign currency gains or losses", so-called "section 987 marked items," can give rise to section 987 foreign exchange gains and losses, and the profit and loss calculation is adjusted accordingly. We describe in more detail below how the Proposed Regulations apply and how some of their aspects differ from the 1991 Proposed Regulations.

1. Some Preliminary Matters: Definition of a Section 987 QBU, Attribution of Assets to a Section 987 QBU and Two Classes of Assets

A "section 987 QBU" is one or more "eligible QBUs" (with the same functional currency) of an owner with a different functional currency.[36] An "eligible QBU" is any set of activities of an individual, corporation, partnership or disregarded entity for U.S. federal income tax purposes ("DE") that constitutes a trade or business and for which separate books and records

[36] Prop. Reg. § 1.987-1(b)(2). The functional currency is determined under section 985 and Treas. Reg. §1.985-1.

are maintained that reflect the assets and liabilities used in conducting these activities.[37] Two (or more) such eligible QBUs of an owner cannot be grouped into a single section 987 QBU unless they share the same functional currency, the owner makes an election and either (i) all are eligible QBUs of the same "section 987 partnership" (as described below) or (ii) none are eligible QBUs of a partnership.[38]

Only individuals or corporations can be "owners" of an eligible QBU; an eligible QBU of a partnership may give rise to a separate QBU only for each of its corporate or individual partners. In addition, a "flat" approach is taken to tiered QBUs—a section 987 QBU cannot be an owner of another section 987 QBU. Thus, if a domestic corporation conducted its UK operations through a disregarded UK subsidiary whose activities constituted a section 987 QBU with the sterling as its functional currency and if this UK subsidiary were owned by a disregarded Dutch subsidiary whose activities constituted a section 987 QBU with the euro as its functional currency, the domestic corporation would be treated as directly owning two separate section 987 QBUs.[39] Further, under the Proposed Regulations, a partnership cannot own or *per se* be a section 987 QBU. Rather, if a partnership conducts activities that give rise to an eligible QBU and this QBU has a different functional currency from a partner (a "section 987 partnership"), the partner is treated as the "indirect" owner of a section 987 QBU through its interest in the section 987 partnership. A partner that owns less than five percent of the capital or profits interest of a section 987 partnership, however, may elect not to apply section 987 with

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37 Section 987 also does not apply to activities that are subject to the Dollar Approximate Separate Transaction Method (DASTM) of Treas. Reg. § 1.985-3. *See* Section 985(a); Prop. Reg. § 1.987-1(b)(3)(i)(C).

38 Prop. Reg. § 1.987-1(b)(2)(ii).

39 *See* Prop. Reg. § 1.987-1(b)(7) example 2.

respect to its partnership interest.[40] It is unclear whether for this purpose a partner with a 4.9% percent interest in the partnership's capital who is allocated 20% of the items of an eligible QBU of the partnership (and correspondingly less of items from other activities of the partnership) would be treated as a less-than-five-percent partner.

This concept of a QBU differs from that under the 1991 Proposed Regulations, under which a "QBU branch" (which conceptually corresponds to the section 987 QBU of the Proposed Regulations) was any QBU of a taxpayer that had a functional currency different than that of the taxpayer.[41] Thus, a partnership with a different functional currency than its owner was *per se* a QBU branch.[42] It was arguably unclear how QBUs in tiered structures were to be treated under the 1991 Proposed Regulations.[43]

Assets and liabilities, and items of income, gain, loss and deduction are generally attributed to a section 987 QBU if they are reflected on a separate set of books and records of the eligible QBU that constitutes or is part of the section 987 QBU.[44] Regardless of the eligible QBU's books and records, however, non-portfolio stock, partnership interests and liabilities incurred to acquire such non-portfolio stock or partnership interests are not attributable to the

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40 Prop. Reg. § 1.987-1(b)(1)(ii).

41 1991 Prop. Reg. § 1.987-1(a). The 1991 Proposed Regulations also exclude QBUs that use DASTM.

42 Some expressed uncertainly whether a disregarded entity with a different functional currency would also *per se* be a QBU branch. *See* Camacho et al., *supra* note 32. The 1991 Proposed Regulations, of course, preceded by several years the "check the box" entity classification regulations. Nevertheless, by analogy to the *per se* treatment of corporations and partnerships as QBUs, it would be odd if disregarded entities would not be similarly treated.

43 *See* Daub Letter, *supra* note 34, Letter from Ernst & Young LLP dated June 19, 2000, to R. Rosenberg (Associate Chief Counsel ((International)), 21 TAX NOTES INT'L 2002 (Oct. 30, 2000) Doc 2000-26753. *But see* Notice 2000-20 II.B.2.

44 Prop. Reg. § 1.987-2(b)(1). Since this attribution rule is relevant solely to determine section 987 gain and loss and the profit or loss of a section 987 QBU, it does not affect other rules of attributing income, deduction, gain or loss as, *e.g.*, the allocation and apportionment rules under section 864.

section 987 QBU.[45] Income, gain, loss and deduction arising therefrom is likewise not attributable to a section 987 QBU.[46]

A section 987 QBU can acquire assets and liabilities either from third persons or as a result of a "transfer" from its owner. A transfer by one section 987 QBU to another section 987 QBU is treated as a transfer by the first QBU to its owner followed by a transfer by the owner to the second QBU ("triangular" approach).[47] Generally, other than when the QBU is held by a partnership, such a transfer would be a disregarded transaction for U.S. federal tax purposes. But for purposes of section 987 it is respected when the asset or liability becomes reflected on the books and records of the section 987 QBU and ceases to be reflected on the books and records of the owner (or another section 987 QBU) or *vice versa*.[48] While the transfer is generally a non-recognition event, gain or loss must be recognized where a section 988 transaction within the meaning of section 988(c) loses its character as a section 988 transaction as a result of the transfer or where the source of exchange gain or loss on such a transaction could change.[49]

For all other purposes, the transaction remains disregarded.[50] Thus, a sale of an asset by one section 987 QBU to another section 987 QBU would not trigger any (non-section

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45 Prop. Reg. § 1.987-2(b)(2). Non-portfolio stock is stock in a corporation in which the owner of the section 987 QBU holds 10% or more by vote or value (applying the stock attribution rules of section 318 in slightly modified form).

46 The 1991 Proposed Regulations, by comparison, excluded from the section 987 QBU's profit and loss calculation any income of a controlled foreign corporation includible by the QBU's owner under section 951(a) and income of a qualified electing fund includible under section 1293(a)(1), but all other dividend income, regardless of the ownership percentage of the QBU branch, was included in the profit and loss of the QBU branch and translated at the spot rate on the date actually or constructively received. Old Prop. Reg. § 1.987-1(b)(1).

47 Prop. Reg. §§ 1.987-2(c)(2) and (c)(9) Example 2.

48 Prop. Reg. § 1.987-2(c)(1) and (2).

49 Prop. Reg. § 1.987-2(c)(8); Prop. Reg. § 1.988-1(a)(10). For the sourcing of section 988 gain or loss, *see* Treas. Reg. § 1.988-4.

50 Prop. Reg. § 1.987-2(c)(2)(iii).

987) income to the former, and the basis of the latter QBU in the asset would be the historic adjusted basis of the asset, translated into the transferee QBU's functional currency at the spot rate on the date the asset is transferred to it. Both the transfer of the asset sold and the transfer of consideration would nonetheless trigger section 987 gain or loss with respect to the net amount deemed transferred, as described more fully in subsection II.D.4 below. By contrast, only *one* transfer occurs for purposes of section 987 when one QBU provides services to another or sells a right in an intangible, namely the transfer of the consideration from the recipient QBU to the QBU that provides the service or right to the intangible.[51]

The different treatment of portfolio and non-portfolio stock investments has a curious effect. Under the Proposed Regulations, if a domestic corporation (DP) that held more than 10% of the stock in a controlled foreign corporation (FS) within the meaning of section 957 (a "CFC") through a section 987 QBU ceased to be a U.S. shareholder in FS (*e.g.*, because FS redeemed a portion of DP's shares in FS or because FS issued additional equity to unrelated persons), DP's shares in FS would become non-portfolio stock, and a transfer would therefore occur from DP to its section 987 QBU. The Proposed Regulations do not state, however, whether a deemed dividend under section 1248 after the deemed transfer of the FS stock to the section 987 QBU would have to be treated as an item of income of the section 987 QBU or would be attributed back to the QBU's owner. In the inverse case (*e.g.*, if the QBU or a person related with DP acquired additional shares or if FS redeemed shares from persons other than QBU, and DP and its affiliates wound up holding more than 10% of the stock of FS) a remittance from the QBU to DP would occur.

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[51] *See* Prop. Reg. § 1.987-2(c)(9) Example 4.

The Proposed Regulations provide for a general anti-abuse 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 U.S. tax under section 987,"[52] and list several factors indicating the presence or absence of a tax avoidance purpose.

The Proposed Regulations distinguish between two classes of assets and liabilities attributable to a section 987 QBU for section 987 purposes. A "section 987 marked item" is an asset or liability reflected on the books and records of the section 987 QBU that (1) would be a section 988 transaction if entered into directly by the owner of the section 987 QBU (and not through the section 987 QBU) and (2) is not a section 988 transaction with respect to the section 987 QBU.[53] Any other asset or liability attributable to the section 987 QBU is a "section 987 historic item."[54] Thus, in the hands of a £-sterling section 987 QBU of a domestic corporation, £-sterling cash, receivables or borrowings would be section 987 marked items. US dollar cash, on the other hand, any section 988 transaction that is not £-sterling denominated and any other asset would be a section 987 historic item.[55]

2. *Exchange Rates*

All calculations under the Proposed Regulations are to be made by reference to the spot rate, the average rate or the historic rate, defined as follows. The "spot rate" is, at any given date, generally the exchange rate in effect on that date.[56] However, an owner may make an

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52 Prop. Reg. § 1.987-2(b)(3).

53 Prop. Reg. § 1.987-1(d). A "section 988 transaction" generally is any financial transaction denominated in or determined by reference to the value of one or more nonfunctional currencies. Financial transactions include nonfunctional currency, indebtedness, forward and futures contracts, and options (but not stock, regardless of the currency in which it pays dividends). *See* Section 988(c)(1).

54 Prop. Reg. § 1.987-1(e).

55 Items determined in the owner's functional currency are therefore, as a technical matter, section 987 historic items. *See Id.*

56 Prop. Reg. § 1.987-1(c)(1)(i). This is subject to the rules of Treas. Reg. § 1.988-1(d) under which, *inter alia*, a taxpayer is required to establish the spot rate to the satisfaction of the IRS.

election, solely for purposes of section 987, to use instead any convention that "reasonably approximates" such a rate.[57] The Proposed Regulations give some examples and state that a rate used for financial accounting purposes presumptively qualifies as a reasonable approximation.

The "historic rate" is (1) in the case of an asset or liability transferred from the owner to its section 987 QBU, the spot rate at the date of transfer and (2) in the case of an asset or liability acquired or entered into by a section 987 QBU, the spot rate at the date the asset is acquired or the liability is entered into.[58]

The "average exchange rate" is a rate "determined by the owner that represents an average exchange rate for the taxable year (or, if the section 987 QBU is sold or terminated prior to the close of the taxable year, the pre-termination portion of the taxable year) computed under any reasonable method," based on daily, monthly or quarterly weighted or unweighted averaging, as consistently applied by the owner.[59]

3. Determination of Profit or Loss of a section 987 QBU

A section 987 QBU separately determines its taxable income (or loss) in its own functional currency and then translates it into US dollars accordingly. Generally, this translation is based on the average exchange rate for the taxable year or, if the owner so elects, a spot rate for the day the item is properly taken into account.[60] Certain items are treated differently:

- Items of income, gain, loss or deduction denominated in or determined by reference to the owner's functional currency are not translated;[61]

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57 Prop. Reg. § 1.987-1(c)(1)(ii).

58 Prop. Reg. § 1.987-1(c)(3).

59 Prop. Reg. § 1.987-1(c)(2). The Code leaves much leeway here, because the "appropriate exchange rate" under section 987(2) is "the average exchange rate for the taxable year of such qualified business unit." Section 989(b)(4). The procedure for determining this rate is left to the Secretary. Section 989(c)(6).

60 Prop. Reg. § 1.987-3(b)(1).

61 Prop. Reg. § 1.987-3(c).

- Deductions allowable in respect of section 987 historic assets for depreciation, depletion or amortization are translated using the historic exchange rate for the property to which the deduction relates;[62]

- Gain or loss recognized on the sale or disposition of a section 987 marked asset (other than cash) is determined by translating the amount realized and the adjusted basis by reference to the spot exchange rate on the last date of the previous taxable year or, if the asset was acquired by or transferred to the section 987 QBU after that date, the date the asset was acquired or transferred;[63]

- Items that are denominated in a currency other than the section 987 QBU's and the owner's functional currency are translated into the section 987 QBU's functional currency at the spot rate on the day the item is properly taken into account;[64]

- Section 988 transactions of the section 987 QBU (other than transactions in the owner's functional currency) are subject to the general rules of section 988 and treated as section 987 historic assets;[65] and

- Gain or loss recognized on the sale or disposition of a section 987 historic asset and cash is determined by translating the basis by reference to the asset's historic exchange rate.[66]

For purposes of section 987, expenses, such as interest, that are not reflected on the QBU's books but are allocable in respect of the QBU under other provisions of the Code and the Regulations are ignored.

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62 Prop. Reg. § 1.987-3(b)(2)(i). Basis recovery with respect to historic assets (*e.g.*, gain or loss on the sale or exchange of asset) and cost recovery (*e.g.*, depreciation or depletion) are determined at the historical exchange rate applicable to the respective asset "to more closely reflect the economic gain or loss to the owner of the section 987 QBU." Preamble, 71 Fed. Reg. at 52886.

63 Prop. Reg. §§ 1.987-3(b)(2)(ii)(A)(*2*) and (b)(2)(ii)(B)(*2*)

64 Prop. Reg. § 1.987-3(d).

65 Prop. Reg. § 1.987-3(e). The last two items are illustrated in Prop. Reg. § 1.987-3(f) Ex. 10: Branch DE of a US domestic corporation has the euro as its functional currency. On January 12, it receives £10,000 in compensation income for services performed on that date, when £1 is worth €1.25. On October 16 of the same year, DE disposes of the £10,000 in exchange for €10,000. The yearly average euro-to-dollar exchange rate for the taxable year is €1 = $1.10. DE's service income is translated from £-sterling into euro at the spot rate and then into US dollar at the average exchange rate, and the US owner has service income of $13,750. The disposition of the £-sterling is a section 988 transaction for DE in which it recognizes a loss of €2,500 (€12,500 of basis and €10,000 amount realized), which translates into a loss of $2,750.

66 Prop. Reg. §§ 1.987-3(b)(2)(ii)(B)(*1*).

4. Section 987 Gain or Loss

Section 987 gain or loss of a taxpayer in respect of a particular section 987 QBU is determined for each taxable year and effectively corresponds to the amount that the net assets transferred between owner and QBU represent as a percent of the "current and accumulated" unrecognized section 987 gain or loss based on the balance sheet of the section 987 QBU.

For each taxable year of the owner (and not, as under the 1991 Proposed Regulations, on a daily basis), the "remittance" by a section 987 QBU to its owner is netted to equal the excess of (1) the value of all transfers of assets from the section 987 QBU to its owner and all assumptions of liabilities of the owner by the section 987 QBU over (2) the value of all transfers of assets from the owner to the section 987 QBU and all assumptions of liabilities of the section 987 QBU by its owner.[67] For example, the amount of an asset transferred by a section 987 QBU to its owner is equal to the asset's adjusted basis in the hands of the section 987 QBU translated into the functional currency of the owner.[68] The exchange rate for the translation is the spot exchange rate on the date of transfer for functional currency, section 987 marked assets of the section 987 QBU and section 987 historic assets.[69]

The owner recognizes section 987 gain or loss for the taxable year in respect of a section 987 QBU in an amount equal to the "remittance proportion" of the section 987 QBU multiplied by the "net unrecognized section 987 gain or loss" of the section 987 QBU, as determined at the end of the taxable year as described more fully below. The remittance

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67 Prop. Reg. §§ 1.987-5(c), (d) and (e).

68 Prop. Reg. § 1.987-5(d) and (e). But gain or loss may be recognized on certain section 988 transactions. *See supra*, note 49.

69 Prop. Reg. § 1.987-5(d) and (e). The "historic exchange rate" that applies to historic assets is in this case the spot rate on the date of transfer. Cash in the functional currency of the owner, of course, need not be translated.

proportion is a fraction equal to the amount of the remittance divided by the aggregate adjusted bases of the gross assets of the section 987 QBU at of the end of the taxable year.[70]

For each taxable year, the annual net unrecognized section 987 gain or loss for that year is calculated as the difference between the balance sheet of the section 987 QBU at the end of the immediately preceding taxable year (taking into account any remittances made during that year) and the balance sheet of the section 987 QBU at the end of the current taxable year after disregarding the remittances made during the taxable year and making several adjustments for transfers to and from, and profits and losses of, the section 987 QBU. The net unrecognized section 987 gain or loss is obtained by adding this gain (or subtracting this loss) from the net accumulated unrecognized section 987 gain or loss for all prior years, as reduced (or increased) by the amount of section 987 gain (or loss) recognized in prior year remittances.[71]

Specifically, the section 987 QBU will prepare a balance sheet as of the date of its inception, each year-end and the date of its termination that shows in the QBU's functional currency the adjusted basis of each asset, the amount of each liability and the amount of the section 987 QBU's functional currency cash that are attributable to the section 987 QBU, except that cash and liabilities in the functional currency of the section 987 QBU's owner are shown in the owner's functional currency.[72] The balance sheet is then translated into the owner's functional currency as follows:[73]

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70 The date the Section 987 QBU terminates is treated as the end of its taxable year, and the remittance proportion equals 1 (or 100%).

71 Prop. Reg. § 1.987-4(b) and (c). Net accumulated unrecognized gain or loss is zero for the first year of the section 987 QBU's existence, but special rules apply to section 987 QBUs that are already in existence at the time these proposed regulations become effective and are subject to the transition rules.

72 Prop. Reg. § 1.987-4(e)(1).

73 Prop. Reg. § 1.987-4(e)(2). "Section 987 Historic items" for this purpose apparently does not include items denominated in the owner's functional currency. *See* Prop. Reg. § 1.987-4(d)(1)(i).

Asset/liability type attributable to section 987 QBU	Exchange rate for translation
Owner functional currency denominated cash, liabilities and other items	None
§987 marked item	Spot rate on the last day of the taxable year
§987 historic item (other than owner functional currency items)	Historic exchange rate

The difference between the year-end balance sheet and that of the previous year is then adjusted to account for changes that are due to transfers from the owner to the section 987 QBU or vice versa or for the profit or loss of the section 987 QBU during the taxable year by (1) adding the amount of the adjusted basis (as of the date of transfer) of all assets transferred from the section 987 QBU to its owner and the amount of all liabilities transferred from the owner to the section 987 QBU, (2) subtracting the amount of the adjusted basis (as of the date of transfer) of all assets transferred from the owner to the section 987 QBU and the amount of all liabilities transferred from the section 987 QBU to its owner, and (3) adding back any section 987 taxable loss or subtracting any section 987 taxable profit (as the case may be) of the section 987 QBU.[74] Transfers of assets and liabilities are translated at the applicable spot rate for section 987 marked items and cash in the functional currency of the section 987 QBU, and at the respective historic exchange rate for section 987 historic assets.

The section 987 gain or loss is sourced based on the asset method under Treas. Reg. § 1.861-9T(g), *i.e.*, based on the average tax-book value of the gross assets.[75] Under this method, the section 987 gain or loss is apportioned between U.S. source and foreign source, and to the separate foreign tax credit limitation baskets under section 904, based on the average total

[74] Prop. Reg. § 1.987-4(d)(2) through (7). The amount of this section 987 taxable profit or loss in the functional currency of the owner is as determined above.

[75] Prop. Reg. § 1.987-6(b)(1) and (2).

value of assets within each such category.[76] This seems contrary to the plain language of section 987, according to which such gain or loss is "sourced" according to the income of the section 987 QBU giving rise to its post-1986 accumulated earnings. The preamble states that the approach "will significantly minimize complexity," and it is in effect a shortcut to tracing income for long periods of time for purposes of section 987 and 904 on the theory that average tax-book values of assets in the year of remittance reflect undistributed post-1986 accumulated earnings.[77]

This method is likewise used to characterize section 987 gain or loss as subpart F income under section 954. The preamble states that "Section 987 is silent on the method of characterizing section 987 gain or loss for purposes of the Code" and bases its authority to treat section 987 gain or loss for subpart F and basketing purposes on section 987(3) and also on section 989(c)(5), which authorizes the Service to "provid[e] for the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer)." The preamble further states that "this characterization is necessary to prevent section 987 from being used as a vehicle to avoid the rules of section §954(c)(1)(D) with respect to certain section 988 transactions," but does not give an example for such a case.[78]

5. *Terminations of Section 987 QBUs*

A termination of a section 987 QBU is treated as a remittance of all of its assets.[79] Any calculations that are otherwise to be made as of the end of the taxable year, *e.g.*, the amount

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76 *See* Treas. Reg. § 1.861-9T(g)(1)(i). As part of the Proposed Regulations, Prop. Reg. § 1.861-9T(g)(2)(ii) was added to provide more detailed rules for determining the average value.

77 *See* Preamble, 71 Fed. Reg. at 52888.

78 *Id.*

79 Prop. Reg. § 1.987-8(d).

of unrecognized section 987 gain or loss, are to be made as of the day of termination.[80] An owner would therefore recognize the full amount of any unrecognized section 987 gain or loss at the time of the QBU's termination.[81]

Under the Proposed Regulations, a section 987 QBU would terminate not only when its activities cease, as may be the case if the QBU sold all of its assets for cash and repatriated the cash,[82] but also if it transferred "substantially all" of its assets to its owner.[83] "Substantially all" has the same meaning as under section 368(a)(1)(C). In other words, a section 987 QBU could be terminated even though it does not cease its activities.[84]

In addition, a section 987 QBU ceases to exist when its owner "ceases to exist" (including in a section 381 transaction, in which tax attributes of the owner may otherwise be inherited by another corporation), except (1) in the case of liquidation of a foreign corporation into another foreign corporation, both of which have the same functional currency, or of a domestic corporation into another domestic corporation and (2) in an asset reorganization[85] where both the transferor and the acquiring corporation are either domestic corporations or foreign corporations (unless the foreign acquiring corporation has the same functional currency as the acquired section 987 QBU).[86] The examples also describe a transfer of a section 987 QBU

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80 Prop. Reg. § 1.987-4(d)(1)(ii).

81 Prop. Reg. § 1.987-8(d).

82 Prop. Reg. § 1.987-8(b)(1).

83 Prop. Reg. § 1.987-8(b)(2).

84 Under the 1991 Proposed Regulations, by contrast, "substantially all" was not further defined and apparently could be construed as deferring a termination until the QBU branch's activities ceased. 1991 Prop. Reg. § 1.987-3(a).

85 *I.e.*, a reorganization described in sections 368(a)(1)(A), (C), (D), (F) or (G). *See* section 381(a)(2).

86 Prop. Reg. § 1.987-8(b)(4) and (c). Under the 1991 Proposed Regulations, by contrast, no termination occurred (1) in the case of a foreign-to-foreign liquidation where the distributee corporation had a different functional currency from the section 987 QBU, or of a domestic-to-domestic liquidation and (2) in an asset reorganization that is not described in section 367(a) and, if described in section 367(b), the transferee had

to a controlled corporation pursuant to section 351 as resulting in the termination of the transferred section 987 QBU,[87] although none of the termination rules above seem to apply.[88] (Neither the contributing person nor its activities nor the QBU's activities disappear.)

Under the Proposed Regulations, a section 987 QBU of a foreign corporation would also terminate at the time the foreign corporation ceased to be a CFC or was acquired in an asset reorganization by a foreign corporation that is not a controlled foreign corporation.[89]

6. Partnerships

As described above, a partnership is not itself a QBU. Rather, each partner is treated as indirectly owning one or more section 987 QBUs in respect of each section 987 partnership that conducts activities that give rise to an eligible QBU that has a different functional currency than the partner. It is therefore necessary to attribute assets and liabilities from the partnership to such a section 987 QBU of a partner. This is to be done "in a manner consistent with the manner in which the partners have agreed to share the economic benefits and burdens (if any) corresponding to such assets and liabilities taking into account the rules and principles of" subchapter K.[90] In short, partnerships are treated as aggregates for section 987 purposes.

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a different functional currency from the section 987 QBU and no U.S. shareholder was required to include in income any section 1248 amount or all earnings and profits amount.

We note that the Proposed Regulations lack a rule for the translation or recognition of exchange gain or loss for assets denominated in the currency of the QBU's old owner and/or currency of the QBU's new owner in the case of an asset reorganization involving two foreign corporations with different functional currencies.

87 Prop. Reg. § 1.987-8(e) Example 2.

88 *See* L.J. Greenwald and J.L. Rubinger, *New Currency Branch Regs Shut Down Abusive Loss Recognition*, 113 TAX NOTES 1085, 1092 (Dec. 18, 2006).

89 Prop. Reg. § 1.987-8(b)(3) and (c)(2)(iii). Under the 1991 Proposed Regulations, the termination would occur only when a U.S. person exchanged 10% or more by vote or value of the foreign corporation's stock during a twelve-month period in a section 1248 transaction.

90 Prop. Reg. § 1.987-7(b).

Determinations of section 987 gain or loss in respect of a partnership interest are made by reference to such an indirect section 987 QBU and treated by the owner of the section 987 QBU as increases or decreases, as the case may be, in the adjusted basis of its partnership interest, which is determined in the partner's functional currency.[91] Items of income, gain, loss and deduction attributable to the section 987 QBU are translated into the partner's functional currency in the general fashion described above, and adjustments to the basis under section 705 are made on the basis of those amounts.[92] Any increases in the partner's liabilities under section 752 are translated into the functional currency of the partner at the spot rate on the date of the increase, and when reduced are translated at the historic rate for that date.[93] Contributions and distributions are likewise determined in the owner's functional currency; distributions give rise to section 987 gains or losses according to the rules described above.

Any shift in the attribution of assets to the indirect section 987 QBU should result in a transfer. For example, contributions by new or other existing partners to the section 987 partnership, or distributions to (including on the retirement of) other partners, should result in transfers to or from a partner's indirect section 987 QBU regardless of whether they in fact result in any transfer between partner and partnership or between the activities of the partnership that give rise to the section 987 QBU and other activities of the partnership.[94]

For purposes of determining the effect of section 988 on such actual or deemed transfers, the owners of the section 987 partnership (*i.e.*, the ultimate corporate or individual owners of the section 987 QBU) are treated also as the owners of the appropriate share of the

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91 Prop. Reg. § 1.987-7(c)(1)(ii)(B) and (c)(1)(i).

92 Prop. Reg. § 1.987-7(c)(1)(ii).

93 Prop. Reg. § 1.987-7(c)(1)(iv).

94 *See, e.g.*, examples 7 and 9 of Prop. Reg. § 1.987-2(c)(9).

assets and liabilities of the section 987 partnership.[95] In other words, deemed transfers of marked items and cash in the currency of the section 987 QBU from the owner to the indirect section 987 QBU must trigger corresponding section 988 gains or losses, and *vice versa*.[96]

When a partner sells, exchanges or otherwise disposes of its interest in a section 987 partnership interest, the section 987 gain or loss in respect of the section 987 QBU is determined first, and the partner's adjusted basis in the partnership interest is increased or decreased accordingly.[97] Unlike in the case of a section 988 transaction,[98] a partner could therefore recognize section 987 gain, but a loss on the sale of the partnership interest. Liabilities of the section 987 QBU (determined in a currency other than that of the partner) are for this purpose translated at the historic exchange rate.[99]

Transfers between two separate eligible QBUs of a partnership are treated in the same manner as transfers between two (direct) section 987 QBUs discussed above. A partner with corresponding indirect section 987 QBUs will therefore be treated as having transferred its attributable portion of these assets and will recognize section 987 gain or loss accordingly. If a partner enters into a transaction with the partnership, the rules are different. To illustrate, assume that a domestic partner of an Australian joint venture sold, through its German section 987 QBU (with euro functional currency), a plane to the Australian partnership in exchange for Australian dollars. Assume further that the Australian joint venture gives rise to an indirect section 987 QBU of the domestic partner, with the Australian dollar as its functional currency. The sale is not a disregarded transaction for United States federal income tax purposes and is not a transfer

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95 Prop. Reg. § 1.988-1(a)(4)

96 Prop. Reg. §§ 1.987-2(c)(8) and 1.988-1(a)(4)(ii); Treas. Reg. § 1.988-1(a)(10).

97 Prop. Reg. § 1.987-7(c)(1)(ii)(B).

98 *See* Treas. Reg. § 1.988-2(b)(8).

99 Prop. Reg. § 1.987-7(c)(2).

for purposes of section 987 between the indirect and direct section 987 QBU. Income or loss from the sale would simply be reflected in the profit and loss determination of the German section 987 QBU, and the indirect section 987 QBU would be treated as having acquired a historic asset.[100]

A partner that owns less than five percent of the capital or profits interests of a section 987 partnership may elect not to apply section 987 with respect to its partnership interest for purposes of taking into account section 987 gain or loss in respect of the indirect section 987 QBU (the "partnership *de minimis* rule"). The less-than-5% partner would still be required to determine its distributive share of the taxable income or loss in respect of the section 987 QBU under the rules of Prop. Reg. § 1.987-3. There are no rules regarding the transition for a partner whose partnership interest drops from five percent or more to below the five percent threshold.

7. Transition Methods

The new rules are fundamentally different from the rules under the 1991 Proposed Regulations and any other of the historic methods for determining the foreign currency exchange gain or loss inherent in branch operations conducted in a different functional currency. The Proposed Regulations accordingly proffer two methods for the transition for existing foreign currency branch operations from its previously used method (the "prior section 987 method") to the new, foreign exchange exposure pool method. A taxpayer (and all controlled foreign corporations in which the taxpayer owns more than 50 percent of the voting power) has to apply the same method to all QBUs subject to section 987 (the "relevant QBUs").

Under the first method, the "deferral transition method," section 987 gain or loss would be determined for all relevant QBUs under the prior section 987 method as of the date

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[100] *See* Prop. Reg. §§ 1.987-2(c)(1)-(3) and 1.987-2(c)(9) Example 4.

preceding the transition date (*i.e.*, the date the Proposed Regulations become first applicable to the relevant QBUs) as though each relevant QBU were terminated, and would be the opening amount of the net unrecognized section 987 gain or loss under the newly applicable foreign exchange exposure pool method. This historically accumulated section 987 gain or loss would therefore not be recognized on the transition date, but would be recognized in the future under the regular rules of the foreign exchange exposure pool method. The assets and liabilities of each relevant branch would be translated at the historic exchange rate, "adjusted to take into account any gain or loss determined" under the deferral transition method.[101] The appropriate "adjustment" in effect means that assets and liabilities generally are translated at the spot rate on the date preceding the transition date.[102]

Under the second method, the "fresh start transition method," all relevant QBUs of a taxpayer subject to section 987 are deemed terminated, but historically accumulated section 987 gain or loss is neither recognized nor used as the opening amount of net unrecognized section 987 gain or loss (in effect, it is not determined at all in the first place). Instead, the assets and liabilities of each relevant QBU are translated, without any adjustment, at the historic rate when acquired or entered into.[103] This method is mandatory for taxpayers that have used "unreasonable methods" for determining section 987 gain or loss. Failing to make such determination in the first place in the past would qualify as an unreasonable method. By contrast, the equity pool method of the 1991 Proposed Regulations and the "earnings only method" are for this purpose reasonable methods.[104] Because of the conformity rule, this fresh

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101 Prop. Reg. § 1.987-10(c)(3)

102 *See* Prop. Reg. § 1.987-10(d) example 1.

103 Prop. Reg. § 1.987-10(c)(4).

104 Prop. Reg. § 1.987-10(a)(2) and (d)(9) examples 1, 2 and 3.

start transition method would therefore be mandatory for *all* relevant QBUs if *one* or more had used an unreasonable method. The Proposed Regulations do not state how long and since when a taxpayer had to use a reasonable method as its prior section 987 method. Nor do they state whether the "prior" section 987 method is the method used at the time of the transition date or whether any method used at any previous time, even if the taxpayer had changed to a different method by the time of the transition date, would have to be tested for its reasonableness. This would of course not be an issue if such a change were treated as a change in accounting method.[105]

Each taxpayer is required to provide detailed reporting in respect of the transitions.[106]

III. COMMENTS

A. Definitional Issues

1. Annual Netting

We agree with the method under the Proposed Regulations of netting transfers and determining the amount of remittances on an annual basis, and commend the Service. The annual netting rule should significantly reduce compliance burdens for taxpayers. We also believe that the anti-abuse rules of Prop. Reg. § 1.987-2(b)(3) should undercut attempts to take advantage of exchange rate changes and accelerate the recognition of gains or losses by a transfer between the owner and its QBU in one direction at year-end followed by an offsetting transfer at the start of the subsequent year.

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105 The method of translating foreign branch profit and loss was held to be an accounting method in *The Travelers Ins. Co. v. United States*, *supra* note 13.

106 Prop. Reg. § 1.987-10(c)(6).

2. *The Distinction Between Historic and Marked Items*

The Proposed Regulations distinguish between historic and marked items. Marked items are valued, for purposes of determining unrecognized section 987 gain or loss, at the spot exchange rate at the end of each year; are maintained, for purposes of determining adjusted basis, in the functional currency of the QBU and not translated into the functional currency of the owner; and receive a basis, upon transfer to the owner, determined by translating the basis in the section 987 QBU's functional currency into that of the owner based on the spot rate on the date of transfer.

Each historic item (other than items determined in the owner's functional currency) is valued, for purposes of determining unrecognized section 987 gain or loss, at its applicable historic rate; is translated, for purposes of determining adjusted basis, into the functional currency of the owner at its applicable historic rate; and receives a basis, upon transfer to the owner, determined by translating the basis in the section 987 QBU's functional currency into that of the owner based on its applicable historic rate.

Thus, if a euro section 987 QBU borrows in euro, the QBU has a marked liability. But it could instead borrow in any other currency, for instance the Swiss franc, and enter into a cross-currency (franc-euro) swap. The amount or basis of the latter would presumably be zero. Instead of a marked liability, the QBU now holds a historic liability and another historic item, neither of which will contribute to the QBU's net unrecognized section 987 gain or loss. Likewise, a euro-denominated note would be a marked asset, but an economically equivalent Swiss franc denominated note plus a cross-currency franc-euro swap constitute two historic items.

This effectively opens up potential for abuse. For a QBU with a functional currency that is depreciating relative to the owner's functional currency, unrecognized section

987 losses on marked assets can be increased by borrowing in a non-functional currency and swapping it into the functional currency for investment in marked assets in that currency. For a QBU with a functional currency that is appreciating relative to the owner's, unrecognized section 987 gain on marked assets can be reduced by borrowing in the QBU's functional currency and investing the proceeds in a historic asset and a currency hedge that has no or little basis.[107] Any marked item can be recast as a "synthetic historic item" in this way, *i.e.*, as a historic item plus a hedge that, although itself a marked asset, has little if any basis. This strategy could make the effects of section 987(3) elective. In the more typical case, the strategy of fabricating synthetic historic assets could diminish unrecognized gain or inflate unrecognized loss, if desired.

Although such a strategy is addressed generally in Treas. Reg. § 1.988-5(a)(8), it should be specifically addressed under the Proposed Regulations. Treas. Reg. § 1.988--5(a)(8)(iii) permits the Commissioner to integrate a borrowing in one currency and a hedge that effectively swaps the borrowing into another currency into a synthetic borrowing in the other currency, but integration is not required in general. We believe that for purposes of section 987, integration of offsetting historic items should be required where the integration results in a marked asset. It may be more difficult to identify abuse in this case because gain or loss due to exchange rate fluctuations is recognized not only upon a taxable disposition of the relevant instrument, as is the case for section 988 transactions, but on remittance. The annual remittance, however, may involve any assets, and not only those that give rise to the section 987 gain or loss, and the amount of the gain or loss is determined regardless of whether the instrument contributing to it (or not contributing to it as a result of bifurcation) has been disposed of.

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[107] Borrowing in an appreciating functional currency would produce unrecognized section 987 loss.

This potential for abuse can also be solved in a simple and straightforward manner by expanding the definition of "marked item" to include all "financial assets" and "financial liabilities." For example, financial assets would be those that are denominated in a currency, *i.e.*, all assets that are section 988 assets in the hands of the section 987 QBU as well as all assets that are section 988 assets in the hands of the owner. Note that this would include items in the owner's functional currency, which under the Proposed Regulations are historic items with a *sui generis* treatment. But they are equally amenable to the planning described above. We believe that the authority under section 987 is adequate to provide for marked item treatment even for items that otherwise would be section 988 items in the functional currency of both the owner and the QBU. As we will note in section III.G.1 below, this expanded definition of marked items would have additional advantages in devising a system for financial institutions, and in our view for all taxpayers. Hence, we believe that an alternative would be to treat all financial assets and financial liabilities as marked items of the section 987 QBU (with appropriate anti-abuse protection).

B. Foreign Exchange Exposure Pool Method

The foreign exchange exposure pool method substantially has two components: calculating the taxable income of a section 987 QBU and determining when and how much section 987 gain or loss is recognized.

We believe that the determination of the taxable income of a section 987 QBU under the foreign exchange exposure pool method is inconsistent with sections 987(1) and (2) and contrary to the legislative intent. As discussed in more detail below, the Proposed Regulations in effect describe a hybrid separate transaction method, whereas in our view Section 987(1) requires that the QBU calculate its income or loss in its own functional currency and that

the aggregate result for the QBU is then translated into the owner's functional currency using the average exchange rate, *i.e.*, the profit and loss method. We also believe that the profit and loss method is significantly simpler to implement for taxpayers.

By contrast, we believe that the determination of unrecognized section 987 gain or loss and the timing of its recognition under the foreign exchange exposure pool method is generally consistent with section 987(3)(A) and not contrary to legislative intent, as summarized above in part II.B above. Specifically, the regulations:

- limit the recognition of exchange gain or loss to that "inherent" in branch earnings and branch capital by separating marked assets, which reflect such inherent gain or loss, from historic assets, which do not;[108]

- adopt a pooling approach, by providing for a single amount of net unrecognized section 987 gain or loss;[109] and

- require the recognition of gain or loss based on that pool with regard to any remittances, and not only remittances of assets (or transfers of liabilities) in which the exchange gain or loss "inheres."[110]

As discussed more fully below, however, we 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, as recommended in section III.A.2 above, 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. We therefore propose below a simplified form of the

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108 *See* CONF. REP. 99-841, *supra* note 25. As argued above, we do not believe, however, that the line between marked and historic items is drawn correctly.

109 *See* S.REP. NO. 99-313, *supra* note 24.

110 *See* CONF. REP. 99-841, *supra* note 25.

foreign exchange exposure pool method that will achieve the same objective but reduce the compliance burden.

1. Determination of Section 987 QBU Taxable Income

Section 987 requires the calculation of income or loss of a section 987 QBU in its functional currency and a translation of this amount into the owner's functional currency using a weighted average exchange rate and the recognition of foreign currency exchange gain or loss resulting from the movement of foreign exchange rates on actual or deemed remittances. We believe that this is not the case under the Proposed Regulations and that foreign exchange gain or loss is in effect recognized in connection with determining the section 987 QBU's taxable income or loss.

This is best illustrated by comparing the 1991 Proposed Regulations with the Proposed Regulations by way of an example.

> Domestic corporation ("DC") starts a new section 987 QBU (the "QBU") with the euro as its functional currency at the beginning of year 1, when $1 is worth €1, by contributing two machines, M1 and M2, each of which has an adjusted basis of $100. During year 1, the QBU manufactures widgets and sells them for €100. The average exchange rate during year 1 is €0.8 for $1 and the spot rate at year end €0.75 for $1. Each of M1 and M2 is subject to straight line depreciation over five years. At the start of year 2, the QBU sells M1 for €100. During year 2, the QBU manufactures widgets and sells them for €20. The average exchange rate for year 2 is €0.667 for $1. On the last day of year 2, when the spot exchange rate is €0.5 for $1, the QBU remits €160 to DC. In year 3, the QBU produces nothing and sells nothing, and at the end of year 3 DC terminates the QBU. The average exchange rate for year 3 and the spot exchange rate for the last day of year 3 is €0.667 for $1.

Under the 1991 Proposed Regulations, the following happens until the termination. Immediately after the transfer of M1 and M2 to the QBU, DC's basis pool equals $200 and QBU's equity pool equals €200. In year 1, QBU has depreciation deductions of €20 each for M1 and M2 and income from sales of €100. The QBU's net income therefore equals

€60, which translates into $75 based on the average exchange rate for year 1. DC's basis pool is increased to $275 and the QBU's equity pool to €260. In year 2, the QBU has net income of €20 (€20 gain on the sale of M1 plus €20 sales proceeds from the widgets less €20 of depreciation on M2), which translates into $30 based on the average exchange rate in year 2. Immediately prior to the remittance, the basis pool is increased by $30 to $305, and the equity pool is increased by €20 to €280. The section 987 gain or loss is calculated as follows: the portion of the basis pool attributable to the €160 remitted equals 160/280 (the fraction of the equity pool remitted) of the basis pool of $305, or $174. Thus, DC recognizes a section 987 gain of $146, the excess of the $320 value of the remittance (*i.e.*, €160/(€0.5/$1)) over the attributable portion of the equity pool (the "basis" in the €160) of $174. The basis pool now equals $131 ($305 - $ 174) and the equity pool €120. In year three, the QBU has a loss of €20 on account of its depreciation, which translates into $30 in the hands of DC based on the average exchange rate in year 3. Thus, immediately prior to termination, the basis pool equals $101 and the equity pool €100. When the QBU is terminated, it transfers M2 with an adjusted basis of €40 (€100 less depreciation of €60) and cash of €60 to DC. The adjusted basis of M2 equals $60, and DC has a basis in the €60 of cash equal to $90. DC will therefore recognize section 987 gain as a result of the termination of $49 ($60 + $90 - $101). If DC had not transferred M2 to the QBU, its adjusted basis in M2 after three years of straight line depreciation would have been $40 rather than $60.

Under the Proposed Regulations, because M1 and M2 are historic section 987 assets, depreciation is calculated based on the historic exchange rate at the time of contribution, and so is the basis for purposes of translating gain on the sale of M1. The results for the profit and loss calculation are therefore as follows:

Year 1	*Item*	*€*	*Exchange Rate (€/$1)*	*$*
	Income from Widget Sales	€100	(average) 0.80	$125.00
Less	Depreciation of M1 and M2	(€40)	(historic) 1.00	($40.00)
	Net Income of QBU	**€60**		**$85.00**

Year 2	*Item*	*€*	*Exchange Rate (€/$1)*	*$*
	Income from Widget Sales	€20	(average) 0.667	$30.00
	Amount Realized on Sale of M1	€100	(average) 0.667	$150.00
Less	Depreciation of M2	(€20)	(historic) 1.00	($20.00)
	Adjusted Basis in M1	(€80)	(historic) 1.00	($80.00)
	Net Income of QBU	**€20**		**$80.00**

Year 3	*Item*	*€*	*Exchange Rate (€/$1)*	*$*
	Income from Widget Sales	€0	(average) 0.667	$0.00
Less	Depreciation of M2	(€20)	(historic) 1.00	($20.00)
	Net Income (Loss) of QBU	**(€20)**		**($20.00)**

The net unrecognized section 987 gain or loss at the beginning of year 1 is zero. DC's net value (in dollars) of the QBU is determined as follows:

Year 1	*Item*	*€*	*Translation Rate (€/$1)*	*$*
Opening Balance	M1 and M2	€200	Historic rate: 1.00	$200.00
	Total			**$200.00**
Closing Balance	M1 and M2	€160	Historic rate: 1.00	$160.00
	Cash	€100	Spot rate: 0.75	$133.33
	Total			**$293.33**
Unrecognized Section 987 Gain/Loss	Accumulated Gain/Loss			$0.00
	Change in Net Value			$93.33
Less	QBU taxable income			($85.00)
	Total			**$8.33**

Note that for year 1, the unrecognized section 987 gain ($8.33) equals the difference between the cash income translated at the average exchange rate and translated at the year end spot rate. Historic items affect the calculation of net unrecognized section 987 gain or loss under the Proposed Regulations only if they are disposed of. If that is the case, they affect QBU taxable income or loss, which then factors into the unrecognized section 987 gain or loss calculation.

Year 2	*Item*	*€*	*Translation Rate (€/$1)*	*$*
Closing Balance	M2	€60	Historic rate: 1.00	$60.00
	Cash	€60	Spot rate: 0.5	$120.00
	Total			**$180.00**
Unrecognized Section 987 Gain/Loss	Accumulated Gain/Loss			$8.33
	Change in Net Value			($113.33)
	€160 Remittance[111]			$320.00
Less	QBU taxable income			($80.00)
	Total			**$135.00**

The amount recognized on the remittance of €160 equals the portion of the unrecognized section 987 gain equal to the fraction of the gross assets (based on the adjusted bases in the QBU's functional currency) remitted, *i.e.*, $77 (€160/€280[112] × $135). The accumulated net unrecognized section 987 gain at the beginning of year 3 is $58 ($135 - $77).

Year 3	*Item*	*€*	*Translation Rate (€/$1)*	*$*
Closing Balance	M2	€40	Historic rate: 1.00	$40.00
	Cash	€60	Spot rate: 0.667	$90.00
	Total			**$130.00**
Unrecognized Section 987 Gain/Loss	Accumulated Gain/Loss			$58.00
	Change in Net Value			($50.00)
	QBU taxable loss			$20.00
	Total			**$28.00**

On termination of the QBU, in addition to $20 of QBU taxable loss in year 3, DC therefore recognizes $28 of section 987 gain and has €60 foreign currency with a basis of $90 and an adjusted basis in M2 of $40.

Because the Proposed Regulations use the historic exchange rate, DC's basis in M2 is the same (*i.e.*, $40) regardless of whether it is depreciated by the QBU or by DC proper. There is, in other words, no phantom exchange gain or loss as a result of retranslating the basis of historic assets. As long as this result is to be maintained, the additional complication of

111 Translated at the spot rate on the date of transfer. *See* Prop. Reg. § 1.987-4(d)(2)(ii)(A).

112 Gross assets in the QBU's functional currency consist of €60 (M2) and €60 of cash retained by the QBU at the end of year 2, and the cash of €160 remitted to the owner is added back.

keeping track of historic exchange rates for each historic asset appears inevitable. This approach resolves the controversial feature of the 1991 Proposed Regulations that "non-economic" gain or loss is recognized in respect of assets whose value is not directly determined by, and subject to, foreign exchange rate fluctuations.

Another key point illustrated by the example can be brought out by comparing the results under the 1991 Proposed Regulations and the Proposed Regulations. Under the 1991 Proposed Regulations, at the end of year 2, DC has had total income inclusions of $279, which consist of $75 (year 1) plus $30 (year 2) of income of the QBU and $174 of section 987 gain. Under the foreign exchange exposure pool method, by contrast, the total income inclusions amount to $242, resulting from $85 (year 1) and $80 (year 2) of income of the QBU and $77 of section 987 gain. At the end of year 3, under the 1991 Proposed Regulations, after the termination, DC has an additional total inclusion of $19, *i.e.*, $30 of net operating loss and $49 of section 987 gain. Under the Proposed Regulations, the net inclusion is $8, *i.e.*, $20 of net operating loss and $28 of section 987 gain. This is summarized in the following table.

Method	***Taxable Income or Loss***			***Section 987 Gain or Loss***		***Total***	
	Year 1	*Year 2*	*Year 3*	*Year 2*	*Year 3*	*End of Year 2*	*End of Year 3*
Proposed Regulations	$85	$80	($20)	$77	$28	**$242**	**$250**
1991 Proposed Regulations	$75	$30	($30)	$174	$49	**$279**	**$298**

The example illustrates that in an environment where the dollar depreciates against the section 987 QBU's functional currency, the method under the Proposed Regulations would result in an inclusion of more income (and less loss) than the 1991 Proposed Regulations. Correspondingly, in an environment where the dollar appreciates against the section 987 QBU's functional currency, the method under the Proposed Regulations would result in an inclusion of

less income (and more loss) than the 1991 Proposed Regulations. Stated differently, the foreign exchange exposure pool method accelerates foreign exchange gain (or loss).

The sale of M1 illustrates this acceleration. DC's gain attributable to the sale of M1 under the foreign exchange exposure pool method equals $70;[113] if DC had not contributed M1 to QBU, it would have recognized gain of $53, by translating the proceeds of €100 at the spot rate into $133,[114] reduced by DC's basis in M1 of $80. The difference in this example results from the difference between the spot rate (€0.75/$1, *i.e.*, the exchange rate in respect of M1 on a stand-alone basis) and the average exchange rate (€0.667/$1, *i.e.*, the exchange rate applicable to the section 987 QBU under the Proposed Regulations) in translating the amount of proceeds, while using the same dollar basis for M1 (*i.e.*, $133 instead of $150). If DC had instead contributed M1 to a CFC (with the euro as its functional currency), the CFC would have had gain of €20 and, assuming for the sake of argument that DC had to include this amount in income as subpart F income, DC would have to include $30 (based on translating at the average exchange rate for year 2).[115] The difference from the Proposed Regulations reflects the fact that under the CFC rules the gain is first determined in its functional currency and then translated at the average exchange rate (€0.667/$1) under section 986 (which has the same effect as translating the basis at such average exchange rates) as compared with basis translation at the historic rate (€1/$1) under the Proposed Regulations.

The foreign exchange exposure pool method thus accelerates section 987 gain or loss recognition, as compared with the profit and loss method reflected in the 1991 Proposed Regulations, by requiring the owner of a section 987 QBU to recognize foreign exchange gain or

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113 *I.e.*, €100, translated at the average exchange rate to $150, less adjusted basis of €80, which is translated at the historic exchange rate to $80.

114 We are assuming that the spot rate is the same exchange rate as on the last day of year 1.

115 *See* section 986(b).

loss as part of the QBU's profit and loss (or "section 987 taxable income") determination. The Proposed Regulations use the historic exchange rate in determining the adjusted basis in the case of a sale or the amount of depreciation, depletion and amortization, but determine the amount of the proceeds at the average exchange rate of the year of disposition. By mixing different types of exchange rates, the Proposed Regulations require a taxpayer to recognize exchange gain or loss, when disposing of a historic asset, as part of, and intermingled with, the calculation of branch profits and losses, as long as the exchange rates are different.[116]

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 exclusively in the QBU's functional currency, and then the net amount be translated using the average exchange rate. The language is relevantly similar to 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."[117] 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

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116 *Accord* D. Forst, *Section 987 Proposed Regulations: A New Regime for Dealing with Functional Currency Issues*, 106 J. TAX'N 90 (February 2007).

117 Conf. Rep. *supra* note 25, at II-674.

available authorities cited above[118] unequivocally reflect that the profit and loss "method is applied to the collective results of the branch's operations."[119] Under this method, "the net profit [or loss] of the branch is first computed in foreign currency"[120] 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.[121] 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. Moreover, as will be described in the next section, the accelerated

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118 *See supra* notes 13, 22 and 24.

119 Ravenscroft *supra* note 17, at 252.

120 *Id.*

121 It has also been argued that for foreign tax credit purposes, the foreign exchange exposure pool method would result in distortions, because the effective rate of foreign taxes of the section 987 QBU in its own functional currency would generally differ from the effective tax rate as translated into the owner's functional currency. We note, however, that such "distortions" are inevitable in one form or another. Even if the profit and loss method aligns the section 987 QBU's foreign taxes and foreign income in its functional currency and in the owner's functional currency, remittances will generally trigger foreign source gain or losses and affect the relevant foreign credit limitation baskets.

recognition of foreign exchange gains or losses under the method of the Proposed Regulations is not essential to the foreign exchange exposure pool method.

2. *The Profit and Loss Method is Compatible with the Determination of Section 987 Gain or Loss Under the Foreign Exchange Exposure Pool Method*

Using the profit and loss method for calculating the taxable income of a section 987 QBU would not affect the determination of net unrecognized section gain or loss of such a QBU. The amounts will, of course, differ on a year-by-year basis (because the recognition of foreign exchange gain or loss is accelerated under the method of the Proposed Regulations), but they will be the same over the life of the section 987 QBU. In other words, the profit and loss method is compatible with the foreign exchange exposure pool method.

Under the Proposed Regulations, the amount of the section 987 QBU's profit or loss must be backed out of the gain or loss in the QBU's balance sheet because the change attributable to the profit or loss is already recognized for tax purposes. A profit therefore reduces the unrecognized section 987 gain (or increases the loss); and a loss increases the unrecognized section 987 gain (or reduces the loss). The profit and loss method proposed above changes the amount of the QBU's taxable income (or loss) and will therefore change, by the same amount, the unrecognized section 987 gain or loss. This gain or loss will then be recognized on a pro rata basis, annually, on the occasion of a remittance.

In the example from the previous section, the net unrecognized section 987 gain of the QBU would increase by $10 (the same as the decrease of the QBU's profit) to $18.33 in year 1 and by another $60 to $195 in year 2, as illustrated in the following table.

Year 1	*Item*	*€*	*Translation Rate (€/$1)*	*$*
Opening Balance	M1 and M2	€200	Historic rate: 1.00	$200.00
	Total			**$200.00**
Closing Balance	M1 and M2	€160	Historic rate: 1.00	$160.00
	Cash	€100	Spot rate: 0.75	$133.33
	Total			**$293.33**
Unrecognized Section 987 Gain/Loss	Accumulated Gain/Loss			$0.00
	Change in Net Value			$93.33
less	QBU taxable income €60		Average rate: 0.80	($75.00)[122]
	Total			**$18.33**

Year 2	*Item*	*€*	*Translation Rate (€/$1)*	*$*
Closing Balance	M2	€60	Historic rate: 1.00	$60.00
	Cash	€60	Spot rate: 0.5	$120.00
	Total			$180.00
Unrecognized Section 987 Gain/Loss	Accumulated Gain/Loss			$18.33
	Change in Net Value			($113.33)
	Remittance			$320.00
less	QBU taxable income €20		Average rate: 0.667	($30.00)[123]
	Total			**$195.00**

What would happen on the remittance? DC would recognize section 987 gain or loss equal to its pro rata portion of the unrecognized section 987 gain or loss, *i.e.*, $111 ((€160/€280) × $195). During the first two years, DC therefore would take into income $75 (year 1) plus $30 (year 2) of section 987 taxable income and $111 of section 987 gain, for a total of $216, instead of $242. The accumulated net unrecognized section 987 gain at the beginning of year 3 would be $84 ($195 - $111), instead of $58.

Immediately before the QBU is terminated, the balance sheet looks as follows:

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122 *I.e.*, €100 of income minus €40 of depreciation. Under the profit and loss method, this is translated at the average exchange rate of €0.80/$1, which results in $75, rather than $85 as under the Proposed Regulations.

123 *I..e.*, €100 of proceeds on the sale of M1, plus €20 of gross income on the sale of widgets, minus €20 of depreciation of M2 and €80 basis of M1, translated at the average exchange rate of €0.667/$1.

Year 3	*Item*	*€*	*Translation Rate (€/$1)*	*$*
Closing Balance	M2	€40	Historic rate: 1.00	$40.00
	Cash	€60	Spot rate: 0.667	$90.00
	Total			**$130.00**
Unrecognized Section 987 Gain/Loss	Accumulated Gain/Loss			$84.00
	Change in Net Value			($50.00)
	QBU taxable loss			$30.00
	Total			**$64.00**

Thus, DC would recognize $64 of section 987 gain on the termination and $30 of loss in respect of the QBU in year 3. Over the life of the QBU's existence, DC would have recognized $250 of taxable income ($216 + $64 - $30), the same amount as under the Proposed Regulations ($242 until the end of year 2 plus $8 for year 3 including the termination), as summarized in the following table.

		Year 1	*Year 2*	*Year 3*	*Total*
Proposed Regulations	*QBU income/loss*	$85	$80	($20)	$145
	Section 987 Gain/Loss		$77	$28	$105
	Total	**$85**	**$157**	**$8**	**$250**
Proposed Regulations Using Profit and Loss Method	*QBU income/loss*	$75	$30	($30)	$75
	Section 987 Gain/Loss		$111	$64	$175
	Total	**$75**	**$141**	**$34**	**$250**

This illustrates that the profit and loss method for calculating a section 987 QBU's taxable income would leave the framework of the foreign exchange exposure pool method for determining section 987 gain or loss untouched.

3. Tracking the Historic Exchange Rates for Each Historic Asset is Not Essential for the Foreign Exchange Exposure Pool Method

The foreign exchange exposure pool method, regardless of whether modified as described above, requires tracking of historic exchange rates on an asset-by-asset basis. Both the amount of net unrecognized section 987 gain or loss and the maintenance of basis of a historic

asset in the owner's functional currency depend on the historic exchange rate as though the owner itself had acquired each asset and never transferred it to the QBU.

This maintenance of historic exchange rates imposes an enormous compliance burden on taxpayers. New accounting systems would have to be designed that track the historic exchange rate for each item other than marked items and items denominated in the owner's functional currency. For certain inventory items, the cost of goods sold might reflect multiple historic exchange rates of the assets used to produce the item.

We grant that we are not aware of any method that would not require a taxpayer to keep track of historic exchange rates (or otherwise of historic U.S. dollar adjusted bases) but would allow the restoration of the adjusted basis of a historic asset in the owner's functional currency when an asset that was originally transferred by the owner to the QBU is transferred back to the owner. We doubt, however, that this should be an indispensable objective under section 987 (about which we will say more below). This is, after all, not mentioned as a goal under section 987 in the legislative history and is not in any way applicable to foreign exchange rate calculations for CFCs. We therefore believe that its importance is outweighed by the formidable compliance burden the foreign exposure pool method under the Proposed Regulations imposes.

We propose to replace the asset-by-asset method of the foreign exchange exposure pool method with a pooling approach. This approach, which we refer to as the "historic asset basis pool method," would most straightforwardly be combined with the expanded definition of "marked item" proposed above.[124] This method would reduce the complexity of the

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[124] We do not believe that the historic asset basis pool method *requires* this expanded definition, but not using the expanded definition would make the determination of the pool's change more complicated and dependent on some slightly arbitrary choices.

foreign exposure pool method, while retaining the general distinction between historic assets (which do not contribute to section 987 gains or losses) and marked assets (which do).

In outline, instead of keeping track of each historic asset with its associated historic exchange rate, the aggregate basis of all historic assets in the owner's functional currency would be maintained as a single pool, somewhat similar to the basis pool under the 1991 Proposed Regulations. On a transfer of a historic asset from a QBU to the owner, the historic asset's adjusted basis in the owner's functional currency would equal its pro rata portion (based on the adjusted basis of the historic asset in the QBU's functional currency as a fraction of the aggregate adjusted bases of all of the QBU's historic assets at the time of transfer) of the pool of aggregate bases in the owner's functional currency. We shall refer to the latter as the "historic asset basis pool." Historic liabilities would be maintained as a similar pool, or at their historic exchange rate. (If, under an alternative discussed above, all financial items were categorized as marked items, there would be no "historic liabilities," and the concept of "historic item" would be coextensive with that of "historic asset" under the historic asset basis pool method.)

The first step in the calculation of the net unrecognized section 987 gain or loss under the Proposed Regulations is the determination of the change in the owner functional currency net value of the section 987 QBU (the "OFCNV").[125] 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

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125 *See* Prop. Reg. § 1.987-4(d)(1).

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.

We propose instead to determine the change in the OFCNV on a pooling basis for historic assets. The year-end (or period-end) historic asset basis pool is a function of (1) the prior year-end historic asset basis pool, (2) the transfer of historic assets between the section 987 QBU and its owner, (3) the increase or decrease in historic liabilities (if any) and (4) the remaining growth (or diminution) in the aggregate adjusted bases of all historic assets, as determined in the QBU's functional currency and translated into the owner's functional currency.

For each transfer of a historic asset, the historic asset basis pool is increased (or decreased) by the amount of the basis of the historic asset, determined in the owner's functional currency, transferred to (or from) the section 987 QBU from (or to) its owner. A transfer from the owner to the QBU would be measured by the owner's adjusted basis in its currency; a transfer from the QBU to the owner would be measured as a portion of the historic asset basis pool (determined in the owner's functional currency) that equals the fraction that the adjusted basis of the transferred asset (in the QBU's functional currency) represents of the aggregate adjusted bases of historic assets of the QBU (in its functional currency). Thus, the historic asset basis pool would be maintained by the owner in its functional currency.[126] We recognize that, because certain currencies may appreciate or depreciate as compared with the US dollar much more rapidly than others, it may be appropriate to require a separate pool for such a currency and, as a backstop, rely on the general anti-abuse rule.

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126 The QBU, as a technical matter, would not need to maintain a separate pool for historic asset bases in its own functional currency because that would be no different than the sum of the adjusted bases of all historic assets.

The third component for determining the change in the historic asset basis pool is the net change in historic liabilities. This assumes or presupposes that historic liabilities are related to historic assets, and we believe that this is a reasonable approach. Historic liabilities could be maintained at their historic exchange rate, or they could be determined and maintained as a pool similar to the historic asset basis pool.[127]

The fourth component for determining the change in historic asset pool requires the translation into the owner's functional currency of the increase (or decrease) in the aggregate adjusted bases of historic assets of the section 987 QBU, as determined in its own functional currency, that is not attributable to transfers of historic assets. This residual change would be the result of (1) recognized income or loss, *e.g.*, assets are sold or purchased, (2) net increase or decrease of marked items, *e.g.*, by borrowing or by using cash (not from current year earnings) for the acquisition of an asset, or (3) a transfer by the owner of marked items, *e.g.*, a contribution of cash to purchase historic assets.

We believe that the basic choice for translating the residual increase or decrease is between two methods of translations. The first would translate the increase/decrease using the average exchange rate for the relevant period. We believe that this method not only would promote simplicity, but also would reflect and reinforce the nature of a section 987 QBU as an entity that determines its relevant items (profit, loss, deduction, bases) by reference to the currency of its predominant economic environment and translates these items (and hence its

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127 *I.e.*, the "historic liability pool" at year end could equal the historic liability pool at the end of the preceding year, increased by the amount of liabilities transferred to (*i.e.*, assumed by) the QBU and incurred by the QBU (as translated into the owner's functional currency at the spot rate), and decreased by the amount of liabilities transferred to (*i.e.*, assumed by) the owner and the amount of liabilities repaid, determining the reduction in the historic liability pool as the portion of the pool at the time of transfer or repayment equal to the fraction the amount of the liability represented of the aggregate amount of all liabilities of the QBU at the time of transfer or repayment.

aggregate results) periodically into the owner's functional currency using the average exchange rate, as witnessed by sections 987(2) and 986(b)(2).

Alternatively, the spot rate could be used for each historic asset on the date of its acquisition or disposition. This translation method would reintroduce at least partially the complexity of the foreign exchange exposure pool method of the Proposed Regulations, but it would still not be necessary to trace the rate for each asset at the date it was originally acquired. While we believe that using the average rate is administratively simpler and consistent with the overall architecture of section 987, a taxpayer might be permitted to make an election to use one or the other method. A change of methods should then be a change in method of accounting, which would be possible only with the consent of the Secretary.

The following illustrates the historic asset basis pool method. Assume the following. On December 31, 2008, when €1 is worth $1.10, a euro section 987 QBU of a U.S. domestic corporation has ten historic assets, each with a basis of €5, marked assets of €50 and no liabilities. The QBU has a historic asset basis pool of $50 and zero net unrecognized section 987 gain or loss at the start of 2009. On March 31, 2009, the QBU transfers two of its historic assets to its owner. On April 30, 2009, when €1 is worth $1.25, the owner transfers a historic asset with an adjusted basis of $10 to the QBU and receives €5 in exchange from the QBU. On June 31, 2009, when €1 is worth $1.35, the QBU borrows €15 and purchases a historic asset for €20. On December 31, 2009, €1 is worth $1.20. The average exchange rate for 2009 is $1.20/€1. The QBU calculates that its profit for the year is €12.

When the two historic assets are repatriated by the QBU to its owner, they reduce the aggregate bases of historic assets in the QBU's functional currency by 20% ((2 × €5)/€50), and their basis in the owner's functional currency is therefore $10 (20% of $50). The sum of the

adjusted bases of the historic assets of the QBU (in euro) at year end is €68: from the starting balance of €50, €10 was transferred to the owner (*i.e.*, subtracted), €8 ($10/$1.25) was transferred to the QBU (*i.e.*, added) and €20 was acquired by purchase (*i.e.*, added). The year-end historic asset basis pool equals $74, *i.e.*, $50 (the starting historic asset basis pool) minus $10 (the transfer to the owner) plus $10 (the transfer from the owner to the QBU) plus $24 (the purchase of the €20 historic asset translated at the average exchange rate of $1.20/€1). If the spot rate of $1.35/€1 on the date of acquisition were instead used, the historic asset basis pool would be increased by $27 to equal $77 at year end.

The net unrecognized section 987 gain or loss is determined by using the historic asset basis pool method as follows. The OFCNV opening balance for 2009 is $50 of historic asset basis pool plus $55 (€50 × $1.10/€1) of marked items, or $105. During the year, the aggregate amount of marked assets was increased by €15 of borrowing and €12 of profit (assuming all cash) and decreased by €5 transferred to the owner and €20 for the purchase of the new historic asset, resulting in a net increase of €2. Moreover, the QBU now has a marked liability of €15. The closing OFCNV for 2009 is therefore $74 of historic asset basis pool plus $44.40 ((€50 + €2 - €15) × $1.20/€1) of marked items, or $118.40 in total. If the spot rate is instead used, the closing OFCNV is $121.40. The OFCNV of the section 987 QBU thus changed by $13.40 (or $16.40 if using the spot rate). The remittance for the year equals the amount of historic asset basis pool transferred to the owner (*i.e.*, $10) plus the amount of marked assets, translated at the spot rate (*i.e.*, €5 × $1.25/€1 or $6.25), minus the transfer of $10 by the owner to its QBU, or $6.25 in total. No liabilities were transferred. The only remaining item is the QBU's profit of €12, which is translated at the average exchange rate to equal $14.40. In accordance with Prop. Reg. § 1.987-4(d), the year-end net unrecognized section 987 gain or loss

therefore equals $5.75 ($13.40 + $16.25 – $10.00 – $14.40); if the spot rate were used for determining the U.S. dollar-basis of the €20 historic asset, the net unrecognized section 987 gain or loss would be $3 higher, or $8.75. This is summarized in the following table, which reflects the closing unrecognized section 987 gain prior to determining the owner's section 987 gain recognized in respect of the remittance for 2009.

2009 OFCNV Determination (Average Exchange Rate Method)		*QBU Functional Currency*	*Exchange Rate*	*Owner Functional Currency*
QBU Net Value Opening Balance	Marked Assets	€50	Spot: 0.909	$55.00
	Historic Asset Basis Pool		n/a	$50.00
	Net Value			**$105.00**
QBU Net Value Closing Balance	Marked Assets	€52	Spot rate: 0.833	$62.40
	Marked Liabilities	(€15)	Spot rate: 0.833	($18.00)
	Marked Items	€37	Spot rate: 0.833	$44.40
	Starting Historic Asset Basis Pool		n/a	$50
	plus Historic Assets Received	€8	Spot rate a date of transfer: 0.80	$10
	minus Historic Assets Distributed	(€10)	n/a—us fractional historic asset basis pool	($10)
	Residual Change in Aggregate Asset Bases of QBU	€20	Average rate: 0.833	$24
	Historic Asset Basis Pool		n/a	$74.00
	Net Value			**$118.40**[128]
Unrecognized Section 987 Gain/Loss	**Opening Balance**			**$0**
	Change in OFCNV			$13.40
	plus: Transfer of Assets to Owner			$16.25
	minus: Transfer of Assets to QBU			($10.00)
	minus QBU Profit	(€12)	Average rate: 0.833	($14.40)
	Closing Balance			**$5.75**[129]

For 2009, DC recognizes section 987 gain or loss as follows. The net amount remitted equals $6.25: $10 of attributable historic asset basis pool for the historic assets

[128] If the spot exchange rate were used, this would equal $139.40, because the residual change amounts would equal $27 and the historic asset basis pool $77.

[129] If the spot exchange rate were used, this would equal $26.75, because the net value would equal $139.40 and the change in OFCNV $34.40.

transferred to the owner, less $10 in respect of the asset contributed by the owner to the QBU, plus $6.25 of euro-cash transferred to the owner. To obtain the gross assets of the QBU at year-end, the net value of the QBU has to be increased by the amount of the marked liabilities, *i.e.*, by $18.[130] The total adjusted gross assets of the QBU in the owner's functional currency thus equal $136.40, the remittance proportion equals 4.38% ($6.25/($136.40+$6.25)), and the owner recognizes $0.25 ($5.75 × 0.0438) of section 987 gain. The 2010 opening balance of unrecognized section 987 gain equals $5.50. If instead the spot rate were used to calculate the historic asset basis pool, the total adjusted gross assets of the QBU in the owner's functional currency would equal $139.40 ($121.40 + $18.00), the remittance proportion would equal 4.29% ($6.25/($139.40+$6.25)), and the owner would recognize $0.38 ($8.75 × 0.0429) of section 987 gain. The 2010 opening balance of unrecognized section 987 gain would equal $8.37.

A higher historic asset basis pool is obtainable at the cost of a higher amount of unrecognized section 987 gain (or less of a loss). There appears to be no easy rule as to which is preferable for a taxpayer, though, because, as the example above shows, too many variables come into play in a QBU with regular and substantial transactions. To illustrate this point further, suppose that in 2010, the €20 historic asset is transferred by the QBU to its owner and nothing else happens all year (there are no depreciable assets). The exchange gain recognized depends on the spot exchange rate at the end of 2010. Assume it has not changed.

Using the average exchange rate method, the historic asset's basis in the owner's hand is $21.76 ((€20/€68) × $74[131]). At year end, the total adjusted gross assets of the QBU in the owner's functional currency equal $114.64 ($136.40 – $21.76), the remittance proportion equals 15.95% ($21.76/($114.64 + $21.76)), and the owner recognizes $0.88 ($5.50 × 0.1595) of

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130 *See* Prop. Reg. § 1.987-5(b)(2).

131 The historic asset bases pool at the end of 2009, which is $74 using the average exchange rate.

section 987 gain. Using instead the spot exchange rate, the historic asset's basis in the owner's hands would be $22.65. At year end, the total adjusted gross assets of the QBU in the owner's functional currency would equal 116.75 ($139.40 – $22.65), the remittance proportion would equal 16.25% ($22.65/($116.75 + $22.65)), and the owner would recognize $1.36 ($8.37 × 0.1625) of section 987 gain.

Thus, over the two year period, the owner recognizes section 987 gain of $1.13 under the average rate method for determining the residual change in the historic asset basis pool and would recognize $1.74 under the spot rate method. In other words, 89 cents more of basis would cost 61 cents of section 987 gain recognition. But in light of netting transfers on an annual basis and unpredictable fluctuations in exchange rates, we do not find an algorithm that would make one method predictably better for a taxpayer than the other.

4. Summary and Comparison

We have proposed the following three changes to the foreign exchange exposure pool method:

1. Marked items should comprise all financial assets and all liabilities, *i.e.*, any items that would be section 988 transactions in the hands of the owner of the section 987 QBU or that are section 988 transactions with respect to the section 987 QBU, including items determined by reference to the owner's functional currency;

2. The taxable income of a section 987 QBU should be determined under the profit and loss method rather than the hybrid method of the Proposed Regulations, *i.e.*, by translating the net income or loss of the section 987 QBU, as determined under U.S. tax principles, by using the average exchange rate; and

3. The change in the OFCNV in the section 987 QBU should be determined by using the historic asset basis pool, rather then translating each historic asset using its own historic exchange rate.

We believe that this conforms with the general function of section 987. The history of section 987 supports the view that section 987 is intended to reflect that branches, in

the currency of their economic environment, determine their gain or loss with reference to the economic environment, *i.e.*, in their functional currency, as though they were stand-alone business operations. Section 987 therefore aims at an accounting system that reflects this reality by setting forth a method for translating the aggregate results of a branch into the owner's functional currency in order to determine taxable income or loss and for ensuring that gains or losses resulting from exchange rate fluctuations are properly captured, both as to timing, character and other categories.

C. Grouping of QBUs

A taxpayer cannot elect to group a directly owned section 987 QBU with an indirectly owned section 987 QBU with the same functional currency. This gives rise to unnecessary remittances, and thus the recognition of section 987 gain or loss. Assume, for example, that a U.S. domestic corporation ("USP") owns all the equity of a disregarded French s.a.r.l ("DE") that in turn owns half of the membership interests in a German GmbH "checked" to be a partnership ("FP"), and that each of DE and FP conducts all its activities through an eligible QBU that has the euro as its functional currency. Because the interest in FP is a non-portfolio interest in a partnership, it is not attributable to DE. In that case, under the Proposed Regulations (which treat FP as transparent for section 987 purposes), USP has two section 987 QBUs, one directly owned ("DE-QBU") and the other indirectly owned ("FP-QBU"). The amount of any net transfer for a taxable year by FP to DE, and by DE to FP, is treated as a remittance from FP to USP followed by a transfer from USP to DE (which is netted with other transfers between USP and DE to obtain the annual remittance).

We believe that this result is unsatisfactory. We therefore recommend that an indirectly owned section 987 QBU should be able to be grouped with a directly owned section

987 QBU by which it is owned and that has the same functional currency. The Proposed Regulations do not explain why optional grouping should be limited to direct section 987 QBUs. Grouping of course recommends itself as a tool of administrative simplification. We believe that administrative simplification is further served by allowing grouping of all section 987 QBUs, whether owned directly or indirectly.

While we are aware that, as a general matter, increased structuring flexibility may allow for increased opportunities for abuse, we are not aware of any specific abuse that expanded grouping would enable. We do not believe, however, that making expanded grouping mandatory rather than elective would be consistent with the statutory requirement that the relevant section 987 determinations are to be made "separately for each such unit."[132] We nonetheless believe that elective grouping is permissible under the broad regulatory authority conferred upon the Service under section 989(c). Although we are not aware of a potential for abuse, we believe that regulations could appropriately require a taxpayer to choose, for each functional currency that is different than the taxpayer's own, between either making section 987 calculations on a QBU-by-QBU basis or else electing, for all eligible QBUs, to have one section 987 QBU for each functional currency. Such an election would limit the potential for abuse.

We nonetheless believe that no remittance should result in the scenario described above, regardless of whether an election is available or made. Thus, when a non-portfolio interest gives rise to an eligible QBU with the same functional currency as a section 987 QBU to which the non-portfolio interest would be attributable but for Prop. Reg. § 1.987-2(b)(2)(i), the eligible QBU should be mandatorily grouped with the section 987 QBU.

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[132] Section 987(1).

The preamble states that grouping of section 987 QBUs greatly simplifies the administration of section 987 because it reduces the number of transfers into and out of section 987 QBUs. We believe that an approach under which a taxpayer is permitted to have one section 987 QBU for any given currency other than its own functional currency will further reduce the number of transfers in and out of section 987 QBUs and the terminations of section 987 QBUs. While we recognize that this approach may result in a different timing of the recognition of section 987 gains or losses as compared to a system without grouping or the grouping system under the Proposed Regulations, we are not aware of any policy reason that would allow for the elective grouping of some section 987 QBUs for reasons of simplification but not for the general grouping of all section 987 QBUs (which would achieve even greater simplification).

Comments are also requested regarding the grouping of section 987 QBUs of owners that are member of a consolidated group. We believe that all QBUs within a consolidated group should be allowed to be grouped into a single section 987 QBU. In other words, a consolidated group should be treated as *one* owner for purposes of section 987. If a consolidated group chooses grouping for the entire consolidated group, it should apply to all section 987 QBUs with the same functional currency. As a result, there would be no terminations of section 987 QBUs when transfers of such QBUs occur within the consolidated group and there would be no remittances when transfers of assets or liabilities between grouped QBUs of different members occur.

D. Terminations

1. Liquidations, Asset Reorganizations and Section 351 Transactions

Under the Proposed Regulations, a termination of a section 987 QBU occurs if its activities cease and it no longer is an "eligible QBU" or if it transfers "substantially all" of its

assets (within the meaning of section 368(a)(1)(C)) to its owner.[133] A section 987 QBU is apparently to be understood to be terminated when the activities are no longer conducted by the same individual, corporation, partnership or disregarded entity,[134] although that is not what the Proposed Regulations state.[135]

We believe that for purposes of section 987 the owner of a section 987 QBU or an eligible QBU in general should not be essential to the QBU. Rather, transfers of section 987 QBUs (or substantially all of a section 987 QBU's assets) should be non-recognition events for purposes of section 987 if they are otherwise non-recognition events under the Code and the amount of unrecognized section 987 gain or loss can be preserved as an item of the transferee corporation.

This is partly reflected in the Proposed Regulations. We thus agree that, as reflected in the Proposed Regulations, no termination should occur (1) where a foreign corporation is liquidated into another foreign corporation, both of which have the same functional currency, or a domestic corporation is liquidated into another domestic corporation, and (2) where both the transferor and the acquiring corporation in an asset reorganization[136] are either domestic corporations or foreign corporations (unless the foreign acquiring corporation has the same functional currency as the acquired section 987 QBU).[137] We are not aware,

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133 *See* Prop. Reg. § 1.987-8(b)(1) and (2).

134 *See* Example 2 of Prop. Reg. § 1.987-8(e), according to which a contribution to a controlled corporation under section 351 would trigger section 987 gain or loss, although the transferor does not "cease to exist."

135 *See* Prop. Reg. § 1.987-8(b)(1) (termination of a QBU when its "activities cease").

136 *I.e.*, a reorganization described in sections 368(a)(1)(A), (C), (D), (F) or (G). *See* section 381(a)(2).

137 Prop. Reg. § 1.987-8(b)(4) and (c). Under the 1991 Proposed Regulations, by contrast, no termination occurred (1) in the case of foreign-to-foreign liquidation where the distributee corporation had a different functional currency from the section 987 QBU, or of a domestic-to-domestic liquidation and (2) in an asset reorganization that is not described in section 367(a) and, if described in section 367(b), the transferee had a different functional currency from the section 987 QBU and no U.S. shareholder was required to include in income any section 1248 amount or all earnings and profits amount.

however, of any rationale for not expanding this exception to certain additional corporate liquidations and asset reorganizations that are nonrecognition events except, as discussed below, for the policy objective of preventing the importation of built-in losses, as such transactions typically would be foreign-to-domestic transactions.

As a general matter, transactions where the transferee corporation has the same functional currency as the transferred section 987 QBU would seem to warrant recognition of unrecognized section 987 gain or loss. In this case, the section 987 QBU technically would cease to exist because its functional currency would no longer be different from that of its owner (it would presumably still be a separate eligible QBU, though). The concept of remittance, therefore, would have no further application, and the recognition of previously unrecognized section 987 gain or loss could not be determined within the framework provided by the Proposed Regulations. In this particular case a liquidation or asset reorganization, therefore, should trigger a termination of the transferred section 987 QBU and recognition of unrecognized section 987 gain or loss.

In all other cases (*i.e.*, an asset reorganization or liquidation of a corporation, domestic or foreign, into another corporation, domestic or foreign, to the extent that the transaction, taking into account section 367, is a nonrecognition transaction and the transferee does not have the same functional currency as the section 987 QBU), unrecognized section 987 gain should be treated in the same manner as any other built-in gain. The transaction should therefore not trigger any gain recognition (except to the extent gain is triggered under the section

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The Proposed Regulations lack a separate rule for the translation or recognition of exchange gain or loss for assets denominated in the currency of the QBU's old owner and/or currency of the QBU's new owner in the case of an asset reorganization involving two foreign corporations with different functional currencies. We believe that the correct translation method would translate the relevant amounts using the spot rate on the date of the transfer, as would generally be the case in a non-recognition transfer.

367 rules).[138] Because of the potential for abusive importation of unrecognized section 987 loss that otherwise might exist if this rule were applicable with respect to a section 987 QBU with such loss, we believe that an exception may be appropriate in situations involving unrecognized section 987 loss.[139] To properly take account of all relevant items in the transferee owner's functional currency, all relevant amounts determined in the transferor owner's functional currency (including the amount of unrecognized section 987 gain or loss) should be translated into the transferee owner's functional currency based on the spot rate on the date of transfer.

The same treatment should apply to section 351 transactions. We disagree with the result in Example 2 of Prop. Reg. § 1.987-8(e) that in every section 351 transfer to a controlled corporation of all (or substantially all) of the assets of a section 987 QBU, the QBU, which is defined as an integrated set of activities, should cease to exist. We believe that a transfer of all or substantially all of the assets of a section 987 QBU in a section 351 transaction should as a general rule not be a termination of the section 987 QBU (to the extent the transfer is not itself a recognition event under section 367); however, for the reason noted above, we believe that an exception may be appropriate in situations involving net unrecognized section 987 loss. As in the case of other nonrecognition asset transfers, however, we believe that section 987 gain or loss should be recognized if the transferee corporation has the same functional currency as the transferred section 987 QBU.

Grouping of section 987 QBUs, however, may result in the recognition of section 987 gain or loss that might not have occurred without grouping, where not substantially all assets of the section 987 QBU are transferred. We believe that this is a reasonable trade-off for the simplification that grouping permits. Suppose that a U.S. domestic corporation ("USP") owned

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138 *See generally* Treas. Reg. § 1.367-5T.

139 Compare Sections 334(b)(1)(B) and 362(e).

all the equity in Spanish DE and Dutch DE, each of which conducts activities all of which give rise to an eligible QBU with the euro as its functional currency, and both DEs were combined into a single section 987 QBU. An incorporation of the Dutch DE into a new Dutch corporation ("FSub", *e.g.*, by "unchecking the box") would not result in a transfer of the entire section 987 QBU. Instead, it would be treated as a transfer by the section 987 QBU of all the assets of the Dutch DE to USP followed by a contribution of those assets to FSub. While section 987 gain or loss would be recognized in respect of this section 987 QBU (to the extent of the net annual remittance), it would likewise be recognized if the two eligible QBUs had not been grouped, because the transferee corporation has the same functional currency as the transferred eligible QBU. If USP instead transferred Dutch DE in a section 351 transaction to a Swiss subsidiary that is a CFC and has the Swiss franc as its functional currency, then, assuming Dutch DE does not represent substantially all of the assets of the combined QBU, section 987 gain or loss would be triggered in respect of the deemed transfer of the assets of Dutch DE (to the extent giving rise to a remittance for the relevant taxable year) regardless of whether section 367(a) applies. We believe that such side-effects of grouping section 987 QBUs do not outweigh its benefits.

We are aware of an alternative proposal to the deemed termination in the case of an asset reorganization and section 351 transactions where the transferee and the transferred section 987 QBU share the same functional currency. Under this proposal, the basis in the stock received in exchange for the transferred property should be adjusted by (1) subtracting the amount of unrecognized section 987 gain from the basis of the stock received (presumably treating the gain like a liability, including the application of section 357) and (2) by adding the amount of unrecognized section 987 loss to the basis of the stock received (effectively by treating the loss like an additional asset transferred to the transferee corporation). *Prima facie*,

such an adjustment in the stock basis would align section 987 more closely with the general statutory framework of section 351. We do not agree with this approach, however, because it does not address the source, character and category of the unrecognized section 987 gain or loss. While in various other situations and for other assets these characteristics are generally not changed as a result of an asset reorganization or a section 351 transaction, they generally would change in the case of unrecognized section 987 gain or loss. We thus believe that the basis adjustment proposal could lead to abuses because it preserves only the amount of the gain or loss, but might modify its source, character and category. For these reasons, we believe that the section 987 QBU should be treated as terminating in this kind of transaction.

2. *Termination of CFC Status*

Under the Proposed Regulations, a section 987 QBU of a foreign corporation is deemed terminated when the foreign corporation ceases to be a CFC (the "CFC termination rule").[140] Under the 1991 Proposed Regulations, a termination was deemed to occur when a U.S. person sold or exchanged 10% or more of the stock in a foreign corporation during a twelve-month period in a transaction described in section 1248.[141] As we understand each of these provisions, the selling 10% U.S. shareholder (or the 10% U.S. shareholder in the case of a termination) would in such case effectively have to include its pro rata portion of the unrecognized section 987 gain or loss in the amount of the sales proceeds that are recharacterized as a dividend under section 1248(a).[142]

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140 Prop. Reg. § 1.987-8(b)(3) and (e) Example 3.

141 1991 Prop. Reg. § 1.987-3(d).

142 Unless the sale or other taxable exchange occurs on the last day of the CFC's taxable year, the 10% shareholder should not be required to include any amount of section 987 gain as subpart F income. *See* section 951(a)(1).

We do not believe that there is any statutory or legislative authority under subpart J for the CFC termination rule. Section 987(3) relates to remittances only, and there is no remittance or any transfer by the section 987 QBU to its owner when a foreign corporation ceases to be a CFC on account of changes in its shareholder composition. Treating this as a termination seems contrary to the very specific CFC framework provided under subpart F and section 1248. Under these rules, the amount characterized as a dividend on a sale by a 10% shareholder is limited by the amount of the CFC's earnings and profits attributable to the stock sold. The CFC termination rule therefore in effect treats net unrecognized section 987 gain as deemed earnings and profits of the CFC. A CFC's earnings and profits are for purposes of section 1248 determined "according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary."[143] Although authority for the termination rule could therefore arguably be found in section 1248(c), it is not clear why unrecognized section 987 gains (and losses) should be different from any other built-in gain or loss item, none of which is marked to market on the termination of CFC status.

In particular, a CFC is not deemed to recognize foreign currency exchange gains or losses attributable to its section 988 transactions when it ceases to be a CFC. There is no explanation in the preamble why section 987 should be any different from section 988 in this respect, and we are not aware of any reason why it should be, including any specific abuse relating to a CFC termination that would be stopped by the CFC termination rule. We therefore believe that the Proposed Regulations should be simplified by eliminating the CFC termination rule.

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[143] Section 1248(c). *Cf.* section 964(a). Arguably, the CFC termination rule would render the earnings and profits rules under the section 1248(c) regulations not to be "substantially similar" to the rules applying to domestic corporations.

E. Source, Character and Category of Section 987 Gain and Loss

Section 987(3)(B) of the Code requires that section 987 gain or loss be "sourced" "by reference to the source of the income giving rise to post-1986 accumulated earnings." The Proposed Regulations, however, would determine source of the gain or loss based on the average tax book asset method described in Treas. Reg. § 1.861-9T(g).[144]

We note that section 987 gain or loss is to be sourced by reference to the income giving rise to post-1986 earnings and profits and agree that rules of apportionment are appropriate. We agree that the method of the Proposed Regulations, looking to assets, is simpler than sourcing by reference to accumulated earnings. But the source of Treasury's authority to implement section 987(3)(B) in this fashion appears doubtful to us. Section 989(c)(5) gives the Service the authority to characterize amounts recognized under section 987, including as subpart F income,[145] but the manner in which source and character is related to the QBU's underlying income (and not assets) appears clearly expressed in section 987(3)(B).

1. Source, Character and Category

We therefore believe that the source, character and category (for purposes of sections 904, 907 and 954) should be determined in relation to post-1986 earnings. Although this adds some complexity, we believe that this complexity is manageable and could be relatively easily implemented, because similar recordkeeping systems exist for purposes of section 902 and 959.[146]

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144 *See* Prop. Reg. § 1.987-6(b). The old proposed regulations allocated using the asset or the gross income method based on the method used by the taxpayer for purposes of allocating interest expense.

145 "989(c) Regulations.---The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subpart, including regulations--- ... (5) providing for the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer), ..."

146 *See* section 902(c) and the regulations thereunder.

We also believe that the method described in section 987(3)(B) is preferable in light of the permission to group several 987 QBUs. As a result of grouping, the composition of assets may differ significantly over time. For example, assume that the relevant section 987 QBU in effect resulted from an election to group two otherwise separate section 987 QBUs, QBU1 and QBU2, and that after several years of operation, QBU1 ceases all of its activities, sells all of its assets and transfers the proceeds from the sale to QBU2. Under the Proposed Regulations, this generally should not result in a termination or otherwise in a remittance to the owner in the year that QBU1 ceases its activities. If the (combined) section 987 QBU made no remittance in the taxable year that QBU1 ceases its operation but remitted an amount (*e.g.*, most of the sales proceeds) in the following taxable year, the remittance may bear little relation for sourcing purposes to the asset composition at the time the remitted amounts were earned.

This creates a potential for distortion and possibly abuse, which would be increased if the grouping rules are expanded as recommended above. We therefore believe that section 987 gain or loss should be sourced based on post-1986 accumulated earnings in a manner analogous to the rules under section 902. We believe that current accounting systems are equipped for this type of recordkeeping.

The potential for distortion under the proposed asset-based apportionment rule is increased if the statutorily mandated profit and loss method is adopted. In that case, all section 987 gain or loss is recognized on remittance and not, as under the currently proposed method for calculating income and loss, partly in the determination of branch income or loss.[147] Changes in asset composition will therefore have a more pronounced effect as recognition of section 987 gain and loss is generally more deferred.

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147 This, of course, in effect sources gain or loss resulting from currency exchange rate fluctuations.

2. *Category Under Sections 904 and 954*

Although section 987(3)(B) speaks only of the "source" of section 987 gain or loss, section 989(c) provides broad authority, and section 989(c)(5) specifically authorizes Treasury to provide "the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer)." This authority naturally includes transactions between a section 987 QBU and its owner, because both a corporate owner and its section 987 QBU are QBUs, and it would be anomalous if an individual owner, although technically not a QBU, would not be treated in like manner.[148]

We therefore believe that Treasury has the authority to promulgate regulations that allocate and apportion recognized section 987 gain or loss for purposes of the foreign tax credit limitation under section 904(d)(1). Moreover, because section 987 gain or loss is conceptually inseparable from underlying income (because it is substantively part of the same transaction), we agree that it is conceptually correct to allocate and apportion in the same manner as the underlying income that gives rise to the gain or loss. This rationale also applies for purposes of categorizing section 987 gain or loss as subpart F income. It is true that under section 954(c) foreign personal holding company income specifically includes gain or loss from section 988 transactions, but does not do so for section 987 gain or loss. And it should not, because it would in our view be incorrect to characterize section 987 gain or loss *ipso facto* as subpart F income. Rather, section 987 gain or loss is an inseparable part of subpart F income to the extent (and only to the extent) it arises from related items of subpart F income.[149]

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148 Treas. Reg. § 1.989(a)-1(b)(2)(i).

149 Section 954(c)(1)(D) also provides that the rule regarding section 988 transactions "shall not apply in the case of any transaction directly related to the business needs of the controlled foreign corporation." We do not believe that a blanket exclusion of section 987 could be derived from this (the exclusion would presumably be justified on the theory that all section 987 gain or loss must relate to the business needs of a qualified business unit). The gain or loss relates to the earnings that give rise to it. It will be active

In sum, whether or not section 987 gain or loss is categorized, allocated and apportioned based on post-1986 earnings or based on gross tax basis of assets, we agree that it is conceptually sound that such gain or loss be allocated to baskets and characterized as subpart F income by reference to the income that gave rise to it, and that Treasury has the authority to do so.

F. The Treatment of Pass-Through Entities

1. Partnerships

As discussed in more detail in section II.D.6 above, the Proposed Regulations adopt an aggregate approach for partnerships with respect to section 987. Each partner therefore has its own "indirect" section 987 QBU to the extent the partner's functional currency is different than that of a set of activities of the partnership. Section 987 gain or loss is therefore not treated as an item of partnership income or loss includible by the partner under section 702(a). A *de minimis* exception would apply at the election of a partner owning less than 5% of the capital or profits interests of a partnership. The 1991 Proposed Regulations reserved on the treatment of partnerships, and unlike the issues discussed so far, there is not experience with a particular set of rules that apply section 987 in the partnership context.

While we believe that the aggregate approach has commendable results, we also believe that there are some problems or anomalies. The rules are enormously complex and require each partner to track not only unrecognized section 987 gain or loss, but also large amounts of records to determine taxable income or loss of each indirect section 987 QBU. This would seem to be the case even under the partnership *de minimis* rule, because a partner would be required to determine its distributive share of the taxable income or loss of a QBU under the

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business income if and to the extent the section 987 QBU generates active business income; to the extent section 988 gain or loss of the section 987 QBU is subject to the exception of section 954(c)(1)(D), so will the related section 987 gain or loss.

rules of section 987 regardless of the relative size of its partnership interest. Every partner of an indirect section 987 QBU therefore would need information regarding each historic asset of the section 987 QBU, which demands significantly more detail than the items of income that a partner would have to take into account on a separate basis under section 702(a).

The complexity is exacerbated because the admission of a new partner or the retirement of a partner could give rise to a change in the assets that are attributable to existing partners in respect of their indirect section 987 QBUs. In addition to making compliance difficult, such changes would translate into (deemed) remittances from and contributions to the indirect section 987 QBUs. This approach seems counterintuitive, as there is no actual transfer of any asset from the partnership to the partner, and recognition of such gain or loss would appear to be "non-economic" at best. Moreover, the burden of section 987 gain on such a deemed remittance may be completely inadvertent and turn what should be a non-recognition event into a potential recognition event for a passive bystander. An entity approach by contrast would generally not have this effect—in that case, section 987 gain or loss would be recognized only when an asset is actually transferred to the partner (if the partnership has a different functional currency than the partner) or, as a partnership item, from the QBU to the partnership, if the partnership has an eligible QBU with a different functional currency than the partnership.

Another compliance problem results from the fact that partnerships can be tiered, but section 987 QBUs cannot. The ultimate partner of a top-tier partnership may have different section 987 QBUs with different functional currencies in respect of lower-tier partnerships. It may be difficult, if not impossible, for the partner to obtain the information from a lower-tier partnership that would allow the partner to perform the calculations required under the Proposed Regulations (some of which would be required even under the partnership *de minimis* rule).

Even a partner to whom the partnership *de minimis* rule did not apply in respect of a lower-tier partnership may not be able to comply with these requirements. This could be avoided by abandoning the flat structure of section 987 QBUs, at least in the partnership context. Again, the solution to this problem points towards adopting an entity approach to partnerships under section 987, which would allow a partnership (like a corporation) to have its own section 987 QBUs.

In sum, we are concerned that taxpayers may not be able to comply with the significant complexity of the partnership rules under the Proposed Regulations. We therefore recommend that partnerships should generally be treated as entities that determine their section 987 gain or loss as a partnership item. Partnerships would then be entities that have a functional currency (*i.e.*, they would remain *per se* QBUs as under the existing regulations under section 989(a)).[150] In this case, unrecognized section 987 gain or loss (as well as section 988 gain or loss) would have to be allocated among partners. We believe that unrecognized section 987 gain or loss should generally be allocated on an annual basis in the same proportions as the corresponding income or loss is allocated and that a partnership should not be free to allocate section 987 gain or loss as a separate item only when actually recognized by the partnership.

As discussed in section III.C above, however, we recommend that an owner who owns a significant interest in a partnership through a QBU be permitted to group any indirect section 987 QBU with its direct section 987 QBU with the same functional currency. We therefore suggest that a partner be permitted to elect the aggregate treatment of the Proposed Regulations for its interest in any partnership in which it actually owns 10% or more of the total interests in partnership capital or profits. Entity treatment would continue to apply to the portion of such a partnership for which such election may not be, or is not, made.

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150 *See* Treas. Reg. § 1.989(a)-1(b)(2)(i).

Certain alternatives may be considered. For example, a 25% rather than 10% threshold may be appropriate. Alternatively, if a partner's ownership is above a certain threshold, aggregate treatment for such partner may be mandated rather than elective.

2. *Transition From and Into the Partnership De Minimis Rule*

The Proposed Regulations do not describe what happens if (1) a partner ceases to be subject to the partnership *de minimis* rule (*e.g.*, because another partner retired) or (2) a partner ceases to be subject to the partnership rules of the Proposed Regulations (because he becomes a less-than-5% partner and makes an election to apply the partnership *de minimis* rule). We believe that under the proposed aggregate rule a partner that becomes subject to the partnership rules of the Proposed Regulations should be treated, solely for purposes of determining section 987 gain or loss, as having contributed its attributable portion of the section 987 partnership to a newly created section 987 QBU with no accumulated unrecognized section 987 gain or loss. In the inverse case, the partner that becomes eligible to elect and does in fact elect to apply the partnership *de minimis* rule should be treated as terminating the indirect section 987 QBU and as recognizing the gain or loss, which as a practical matter may result in elections in loss situations, but not in gain situations. We note that a *de minimis* rule and a transition rule would not be necessary if the section 987 determinations were made under the entity approach at the partnership level.

3. *S Corporations*

Comments have been requested on how the Proposed Regulations should apply to S-corporations.

We believe that an S-corporation should be treated like a C-corporation for purposes of section 987. In other words, any section 987 QBU should be treated as owned directly by the S-corporation, and shareholders should not themselves be treated as owning

indirect section 987 QBUs. Section 987 gain or loss would therefore be recognized only to the extent of the remittance proportion of the unrecognized section 987 gain or loss and effectively allocated to shareholders on a pro rata basis. Because all shareholders of an S-corporation are U.S. persons, and because an S-corporation has a single class of equity interests, this would not permit any abuse, including in the case of a transfer of shares. In that case, a shareholder's portion of the unrecognized section 987 gain or loss would in effect be treated as any other built-in gain or loss of the S-corporation.

4. Trusts and Estates

In general, investment trusts would not be a QBU because they would not be engaged in a trade or business. Accordingly, section 987 would have no application to such trusts.

In nearly all cases in which a trust does conduct a business, the trust will be a traditional trust (generally, a family trust, but in any event a non-investment trust). Further, within such category of trusts, a section 987 QBU would be a relatively unusual occurrence. Against this backdrop, we believe that it would be preferable from the standpoint of simplicity and administration to have the trust itself be treated as the owner of a section 987 QBU on an entity basis, whether the trust is a simple trust or a complex trust.

In certain cases, an estate may conduct a business, and in relatively rare cases, that business may be conducted in a different functional currency. Estates, like complex trusts, may accumulate income. Like trusts, they differ from commercial vehicles such as typical partnerships in that the relevant beneficiaries/owners are not commercial investors (and typically are family members). For these reasons and for simplicity, we suggest that an estate, and not its beneficiaries, be treated as the owner of the relevant section 987 QBU for section 987 purposes, thus permitting QBU records and reporting to be maintained by the trustee.

G. Financial Institutions, RICs and REITs

The Proposed Regulations reserve, and Treasury and the Service asked for comments on, the treatment of "financial entities." These specifically include banks and insurance companies, but also "leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts".[151]

1. Banks

Banks typically operate through branches in different financial centers that, for reasons of the predominant economic environment, including regulatory and accounting reasons, have functional currencies different from the home office. Each such branch typically engages in multiple transfers every day between the owner and the branch or with its sister branches in addition, of course, to transactions with customers that generate income to the branches. Moreover, transactions of any given branch may be in any currency, not only (even though in general predominantly) in its own functional currency. For regulatory purposes and under FAS 52 for accounting purposes, a branch does not distinguish between transactions that are in its functional currency (marked items within the meaning of the Proposed Regulations) and those that are not (historic items). The Proposed Regulations (if applicable to banks) would require another system of recordkeeping and accounting for tax purposes that is at odds with existing systems. As already stated, the foreign exchange exposure pool method of the Proposed Regulations would require an enormous amount of recordkeeping. We believe this is especially pronounced for bank branches that engage in many transactions with sister branches and customers involving financial assets that are historic assets.

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[151] *See* Prop. Reg. § 1.987-1(b)(1)(iii); 71 Fed. Reg. 52880.

We are aware of a proposal that section 987 gain or loss should be determined annually based on a deemed annual liquidation and termination of each branch. That proposal did not also maintain an alternative method for calculating unrecognized section 987 gain and loss. It therefore would continue to require the use of historic exchange rates for all assets, although all assets that were held on the date of the last deemed liquidation would be determined by reference to a single historic rate, *i.e.*, that of the date of the last preceding annual deemed termination. While this may simplify matters somewhat, this method might be seen as a disguised form of the net worth method for determining branch income on an annual basis, which would be contrary to section 987 and its legislative history. In any case, it does not address the numerous transactions of the branch involving historic assets that are financial assets, few of which are likely to be held for more than one year.

We recommend that, instead, as we suggested more generally in section III.A.2 above, banks in particular be permitted to treat all financial assets as marked assets. Although this would allow items in a functional currency other than the section 987 QBU's to affect net unrecognized section 987 gain or loss, we understand that a bank branch with a given functional currency will generally hedge its exposure in non-functional currency. In other words, the net assets and liabilities in a non-functional currency generally will be balanced so as to result in only small and unpredictable effects on unrecognized section 987 gain or loss. We think this would greatly reduce the complexity that banks otherwise would face, without increasing the risk for abuse. We believe that the potential for abuse should be substantially eliminated by annual netting and by the proposed anti-abuse rules under Prop. Reg. § 1.987-2(b)(3) and (c)(7).

We believe that this proposal, together with our other proposals for modifying the foreign exchange exposure pool method (*i.e.*, using the profit and loss method and using the

historic asset basis pool method), would address to a reasonable extent the issues raised by branches that engage in multiple and continual transfers. Therefore, in our view, this modified foreign exchange exposure pool method should be considered for financial institutions.

2. *Real Estate Investment Trusts (REITs)*

Comments have been requested regarding the application of section 987 to REITs. The preamble indicates that, until regulations are issued, REITs must apply a reasonable method, consistently applied, which would include "a method that imputes section 987 gain or loss to earnings but not capital" and the method of the 1991 Proposed Regulations.[152] We believe that some problems relating to foreign currency exchange fluctuations that are specific to REITs would be best resolved if real estate assets of a section 987 QBU were treated as marked assets. Others, however, in our view require legislative action.

a. Background

Section 856(c) requires that, of a REIT's gross income each year, at least 75% must come from specified real estate sources and at least 95% from specified real estate and passive income sources. In general, income and gain from foreign real estate and foreign real estate mortgages qualify for purposes of this test,[153] but gain from foreign exchange rate fluctuations is not specifically mentioned as qualifying for either of these two tests. Prior to the adoption of subchapter J in the TRA, it was generally believed that the portion of the income or gain from transactions in foreign real estate, or other foreign assets, that was attributable to exchange rate movements would have the same character as the underlying transaction for purposes of the 75% and 95% REIT gross income tests.[154]

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152 *See* 71 Fed. Reg. 52880f.

153 *See* Rev. Rul. 74-191, 1974-1 C.B. 170.

154 *See* Real Estate Investment Trusts (Lynn and Bloomfield, West 2006 ed.) at ¶6:63.

In several older private rulings the IRS disagreed with this view.[155] REIT status therefore could have been jeopardized if more than 5% of its income consisted of foreign currency gain or other income not listed in the statute. Recently, however, the Service issued Notice 2007-42,[156] according to which a REIT may apply the principles of the Proposed Regulations to determine whether section 987 gain is derived from qualifying REIT income, *i.e.*, by using the asset method described above.[157]

A REIT making investments in foreign real estate generally will be treated as having a branch in that country, which generally has a choice to elect as its functional currency the local currency or the U.S. dollar. Either choice carries substantial risks for the REIT. If it uses the U.S. dollar as its functional currency, foreign exchange gain or loss can be triggered whenever the branch engages in a section 988 transaction like borrowing and lending in the local currency or engaging in various foreign currency hedging transactions. If the branch chooses the local currency as its functional currency, it will be a section 987 QBU and will recognize section 987 gain or loss with respect to its remittance proportion for each year. Because a REIT generally must distribute at least 90% of its net income for the year to maintain its ability to deduct the dividends it pays to its shareholders, the section 987 QBU will generally remit significant amounts of its annual net earnings. The Proposed Regulations appear to exacerbate this situation by distorting the economic position of a section 987 QBU of a REIT. The section 987 QBU would typically generate net unrecognized section 987 gain or loss if it incurs a local currency borrowing (a marked item) to acquire foreign real state (a historic asset), which generates a stream of local currency income (a marked asset) while, under the Proposed

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155 *See, e.g.*, PLR 199947030 and PLR 200532015.

156 *See also* Rev. Rul. 2007-33, 2007-21 I.R.B. 1281.

157 We note that the Notice 2007-42 did not expressly state how to treat a section 987 loss.

Regulations, depreciating the real estate asset based on the historic exchange rate applicable to the real estate.

REITs have traditionally resorted to setting up what is in effect a subsidiary REIT (with 99 other shareholders) for investments in foreign real estate. To avoid the risk of generating disqualifying amounts of foreign exchange gain or loss, in numerous cases a subsidiary REIT has obtained a ruling from the IRS that it may use the local currency as its functional currency.[158] The subsidiary REIT therefore does not generate foreign currency gain under section 988 in respect of its transactions denominated in the foreign currency, and it does not have a branch that could generate foreign currency gain on a remittance. In addition, the distribution of a dividend from the subsidiary REIT to the parent REIT generally does not generate foreign currency gain.[159]

While the recently issued Rev. Rul. 2007-33 and Notice 2007-42 have alleviated concerns that section 988 transactions and section 987 gain would generate disqualifying income, we believe that the Proposed Regulations, as applied to REITs, still would result in distortions in the timing and amount of foreign exchange gain (or loss) of a REIT section 987 QBU.

b. Proposal for Regulations under Section 987

We believe that additional REIT-specific adaptations of the foreign exchange exposure pool method are warranted beyond the interim guidance of Notice 2007-42. Specifically, we believe that real estate assets should be treated as marked assets. Alternatively,

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158 *See, e.g.*, PLR 200625019. A ruling is required because a REIT must be a domestic corporation and therefore must use the U.S. dollar as its functional currency absent a ruling. *See* Treas. Reg. §§ 1.985-1(b)(1)(iii) and 1.989(a)-1(b)(2)(i).

159 Because the subsidiary REIT is a domestic corporation, section 986(c) should not apply. We note that foreign currency distributed to the parent REIT is a section 988 transaction and may generate future foreign exchange gain or loss under section 988(a).

borrowings incurred to acquire real estate assets could be treated as historic items rather than, as under the Proposed Regulations, marked items; but we believe that this would create additional problems.

Generally, if the foreign exchange exposure pool method of the Proposed Regulations were adopted for REITs, and assuming that (contrary to the practice described above) a REIT operates through a section 987 QBU, a borrowing or hedging transaction with respect to foreign real estate assets would be a marked item,[160] but the corresponding foreign real estate would be a historic item. (Real estate mortgages held as assets and denominated in the section 987 QBU's functional currency, on the other hand, would be marked items.) This would create non-economic unrecognized section 987 gains (or losses) of ordinary character and offsetting capital losses (or gains) in respect of the real estate when it is sold or exchanged (in a non-tax free exchange) at a possibly much later time. The requirement that a REIT distributes at least 90% of its income could cause cash flow problems if significant section 987 gains were recognized on a repatriation. Such gains could result when the functional currency of the section 987 QBU depreciated and the QBU had borrowed in that currency.

There are two general approaches to this mismatch: either all real estate assets could be treated as marked items, or all borrowings and all hedgings in respect of real estate assets by the QBU could be treated as historic assets. We believe that the first approach best avoids the creation of non-economic gain, mismatch in character and potential pressures on cash distributions.

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160 This is the case under the Proposed Regulations if the borrowing is incurred in the functional currency of the QBU (as typically would be the case). Under the expanded definition of "marked item," as recommended, this would be the case for any borrowing by the QBU from persons other than its owner or sister QBUs.

Under this approach, *all* real estate assets would be treated as marked assets (whether they are debt-financed or hedged or neither). This could give rise to unrecognized section 987 gain or loss in the case of unhedged or non-debt financed real estate assets (other than real estate mortgages), but it would not give rise to unrecognized section 987 gain or loss in respect of debt-financing. In addition, the portion of the gain or loss on a sale or other taxable exchange of a real estate asset would be offset by the related loss or gain on the repayment of the related borrowing. Moreover, this approach would avoid a mismatch between rental income on real estate, which is translated based on the average exchange rate, and depreciation of the real estate to the extent the real estate asset is a marked item, as would be the case under the Proposed Regulations. (Note that adoption of the profits and loss method, as recommended above, would avoid the mismatch regardless of how real estate assets are characterized for this purpose.)

While this approach generally would reduce the amount of unrecognized section 987 gain or loss and prevent mismatches of character, it would not avoid section 987 gain or loss for a REIT section 987 QBU. We commend the Service for the special "character rule" of Notice 2007-42 that characterizes recognized section 987 gain (or loss) for purposes of the REIT income tests in relation to the underlying income of the QBU. As discussed above, we believe that Treasury generally has the authority to characterize section 987 gain or loss according to the related income and gain that give rise to it, and we believe such authority is properly exercised for purposes of the REIT income tests.[161]

Our discussion has assumed that the REIT section 987 QBU borrows or hedges (and also may hold real estate mortgage loans denominated) in its own functional currency. In contrast to functional currency transactions, we do not believe that non-functional currency

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[161] See the discussion in the last two paragraphs under the caption "Law and Analysis" in Rev. Rul. 2007-33.

borrowing, hedging or mortgages should be marked items. The purpose of matching assets with liabilities is to avoid non-economic section 987 gain or loss, which in our view would often result where the effects of foreign exchange rate fluctuations in respect of foreign real estate assets and corresponding foreign currency debt or hedges do not in effect offset each other. We believe that this purpose would generally be satisfied for a foreign branch of a REIT by making all real estate assets marked assets, and that the proposed anti-abuse rules and, as recommended, an anti-abuse rule that prevents the conversion of marked liabilities (or hedges) into synthetic historic items would curtail any attempts to fabricate section 987 losses (or gains).

c. Alternative Approaches

Instead of treating *all* real estate assets of a REIT section 987 QBU as marked assets, a slightly modified approach would treat real estate assets of a section 987 QBU of a REIT as marked assets only if, and to the extent that, the REIT identifies the real estate assets (other than real estate mortgage loans) as hedged, or acquired with the proceeds from a related borrowing, in the functional currency of the QBU. Otherwise, such assets would be historic assets. The obvious disadvantage of this approach is that it would require rules for converting the relevant real estate assets from marked assets to historic assets, and *vice versa*, whenever the hedging or amount of related borrowing changes. Moreover, it would require treating such real estate assets partially as historic assets and partially as marked assets if they are only partially debt financed (as will usually be the case for debt-financed property). Although, in principle, rules similar to those under section 988(d) could be employed for "legging into or out of" marked-asset status, in practice this is unnecessarily complex as compared to treating all real estate assets of a REIT section 987 QBU as marked assets. It also would not avoid the mismatch in the calculation of rental income and related depreciation described above (unless the profit and loss method, as recommended, were adopted).

Instead of treating real estate assets (in whole or in part) as marked assets, borrowings of a REIT section 987 QBU could be treated as historic items. In that case, neither the QBU's assets (other than real estate mortgage loans) nor its liabilities would give rise to unrecognized section 987 gain or loss.[162] This method would work with the foreign exchange exposure pool method of the Proposed Regulations. It would not work with the historic asset basis pool method (recommended above), unless that method included a corresponding pool for historic liabilities and for determining the amount of the deemed reissuance of the loan in a manner analogous to that of determining the adjusted basis of a historic asset that is transferred to the owner.

Treating liabilities as historic items would require a separate treatment of gain or loss on the repayment of principal. Conceptually, although real estate assets would remain historic assets and would not give rise to foreign exchange gain or loss under section 987, from the REIT QBU owner's perspective any borrowing in a currency other than the owner's functional currency would still give rise to foreign exchange gain or loss when the principal amount is repaid, because the borrowing would be treated as a section 988 transaction of the owner. When the loan is repaid, as a result of foreign exchange rate fluctuations, the principal amount (in the owner's functional currency) will typically differ from the amount of originally borrowed. While Rev. Rul. 2007-33 has effectively removed concerns that such gain would fail to be qualifying REIT income, the mismatch between depreciation deductions (calculated at the spot rate) and rental income would still be present. Depreciation would continue to be translated at the historic exchange rate, and rental income would be translated similar to interest income on

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[162] The owner's assumption of a borrowing of the QBU should then be treated as a (i) a deemed transfer of the principal amount of the borrowing plus accrued interest thereon to the QBU, followed immediately by (ii) a deemed repayment of the borrowing by the QBU and (iii) a reissuance of the loan by the owner at the historic exchange rate applicable to the borrowing.

a foreign currency denominated loan under section 988, *i.e.*, at the spot rate or the average exchange rate at or for the relevant dates or periods.[163]

We therefore believe that all real estate assets of a REIT section 987 QBU should be treated as marked assets and, in accordance with Notice 2007-42, such a QBU's section 987 gain or loss should be characterized for purposes of the REIT income tests based on the underlying income and gain that give rise to section 987 gain or loss.

H. Transition Methods

For the deferral transition method, the accumulated section 987 gain or loss would serve as the opening balance of the net unrecognized section 987 gain or loss, and assets and liabilities generally would be translated based on the spot rate on the date of transition. The fresh start method, by contrast, would start with a zero balance and require a translation of asset bases and liability amounts based on historic exchange rates at the date acquired or incurred. The availability of two transition rules seems overly generous to taxpayers, and we believe that the fresh start method would be sufficient. Although part of the advantage of two transition methods is somewhat reduced by the uniform transition rule required for all section 987 QBUs of a taxpayer, the effect of the elections will be very one-sided. On the other hand, we recognize that the deferral transition method may be considered most appropriate for those taxpayers who have complied with the 1991 Proposed Regulations.

We note that a single method would also avoid an unintended quirk in the Proposed Regulations. A taxpayer must employ the same method for all QBUs and CFCs controlled by it. But in principle two taxpayers could own more than 50% of the voting power or stock (as determined in section 957(a)) of a single CFC as a result of the constructive ownership

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163 *See* Treas. Reg. § 1.988-2(b).

rules of section 958(b) and therefore either may not be able to use the same method in respect of the CFC or may be forced to use the same transition rule. We do not believe that this result is intended, and Treasury should clarify that the conformity rule applies only to actual, not constructive ownership, in case more than one transition rule is kept in the final regulations.