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Report No. 1488
February 12, 2024

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel
and Deputy Chief Counsel
(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report No. 1488 - Report on Proposed Regulations under Section 987

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1488 of the Tax Section of the New York State Bar Association, which discusses proposed regulations under Section 987.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully Submitted,

Jiyeon Lee-Lim
Chair

Enclosure

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Report No. 1488

New York State Bar Association Tax Section

REPORT ON PROPOSED REGULATIONS UNDER SECTION 987

February 12, 2024

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REPORT ON PROPOSED REGULATIONS UNDER SECTION 987[1]

I. Introduction

This Report provides select comments on proposed regulations (the "***Proposed Regulations***")[2] issued by the Department of the Treasury and Internal Revenue Service (together, "***Treasury***") under section 987[3] on November 14, 2023. We have previously provided comments on the regulations proposed in 2006, submitted on January 3, 2008 (the "***2008 Report***")[4] and to Notice 2017-57, regarding changes to the regulations finalized in 2016 (the "***2018 Report***"),[5] submitted on January 22, 2018.

Part II of this Report contains a summary of our recommendations. Part III contains an overview of those portions of the statutory and proposed regulatory framework for section 987 that are relevant for the Report. Part IV contains a detailed discussion of our recommendations. The Report addresses specific issues with respect to which we have comments and recommendations but does not address all aspects of section 987 and the Proposed Regulations.

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1 The principal authors of this Report are Eric Wang, Lee Holt, and Gloria LaBerge. This Report reflects comments and contributions from Eli Dubin, Jiyeon Lee-Lim, Howard Wiener, John Lutz, and Michael Schler.

This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

2 Notice of Proposed Rulemaking and Partial Withdrawal of Notice of Proposed Rulemaking, Income and Currency Gain or Loss With Respect to a Qualified Business Unit, 88 Fed. Reg. 78134 (Nov. 14, 2023).

3 Except as otherwise noted, all "***Section***" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "***Code***"), references to "***Treasury Regulations***" are to the Treasury Regulations promulgated thereunder.

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

5 New York State Bar Ass'n Tax Section, *Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss* (Report No. 1386, Jan. 2018).

II. Summary of Principal Recommendations

The following is a summary of the principal recommendations in this Report.

1. We commend the IRS and Treasury for providing the current rate election, which would provide relief for taxpayers who seek a simpler and practical method to address section 987. However, we recommend that the IRS and Treasury adopt a lookback rule allowing suspended section 987 loss to be recognized to the extent that section 987 gain was recognized in a prior taxable year. While we do not believe it to be necessary, if the IRS and Treasury were concerned about gains recognized under prior rules, it would be possible to limit the lookback rule to section 987 gain recognized posttransition.

2. Pretransition loss should be treated as net unrecognized section 987 loss which becomes suspended section 987 loss upon an event that would give rise to recognition of such loss.

3. Suspended section 987 loss should be recognized upon the liquidation of an owner of a section 987 QBU in a section 331 liquidation to the extent of gain recognized on the liquidation by the liquidating corporation.

4. The rule providing that section 987 gain or loss that is assigned to a subpart F income group under the asset method is treated as foreign currency gain or loss attributable to section 988 transactions not directly related to the business needs of the CFC should be eliminated and should

be replaced by a rule characterizing section 987 gain or loss by reference to subpart F income groups. We further recommend that if the rule under the Proposed Regulations is retained, a different rule should be applied to taxpayers that make a current rate election, which rule should provide that gain or loss is characterized by reference to subpart F income groups. Such different rule should not apply to pretransition gain or loss for taxpayers that do not make a current rate election.

5. Consideration should be given to the effect of the Proposed Regulations on taxpayers' corporate alternative minimum tax ("***CAMT***").

III. Background

A. Subpart J

As part of the Tax Reform Act of 1986 (the "***TRA***"),[6] Congress added subpart J to the Code, which adopted the concept of functional currency for purposes of determining foreign currency gains or losses for U.S. federal income tax purposes.[7] Except when required to use the U.S. dollar as its functional currency,[8] the functional currency of a qualified business unit ("***QBU***")[9] is generally the currency of the economic environment in which a significant part

6 Pub. L. No. 99-514, 100 Stat. 2085.

7 All determinations under the Code are to be made in the taxpayer's functional currency unless otherwise provided in regulations. Section 985(a).

8 Section 985(b)(1)(A); Treas. Reg. § 1.985-1(b).

9 A QBU is any clearly identified and separate unit of a trade or business which maintains separate books and records. Section 989(a). Corporations, partnerships (except section 987 aggregate partnerships), trusts, and estates are "per se" QBUs of shareholders, partners, and beneficiaries, respectively. Treas. Reg. § 1.989(a)-1(b)(2)(i). Activities of a corporation, partnership, trust, estate, or individual may also qualify as a QBU. Treas. Reg. § 1.989(a)-1(b)(2)(ii).

of the activities are conducted.[10] Subpart J provides two different regimes—those of section 987 and section 988—for the treatment of transactions denominated in a nonfunctional currency.

Section 988 applies to certain transactions (referred to as "section 988 transactions") determined by reference to a nonfunctional currency on a transaction-by-transaction basis. Section 988 transactions include investments in nonfunctional currency, holding or issuing debt instruments denominated in a nonfunctional currency, and entering into certain derivatives of nonfunctional currency and/or nonfunctional currency-denominated debt such as futures, forwards, options and notional principal contracts.[11]

Section 987 applies to business activities carried on in a currency environment different than the taxpayer's own functional currency. Specifically, section 987 generally applies when a taxpayer (referred to as the "owner") has a QBU that operates in a functional currency that is different from that of the owner. The activities of the trade or business as well as the assets and liabilities used in it (with certain exceptions) constitute a "section 987 QBU."[12]

B. Section 987

Section 987 itself is concise. For each QBU, the taxpayer should: (1) determine taxable income at the QBU level in the QBU's functional currency, (2) translate this amount into its own functional currency at the appropriate exchange rate, and (3) make proper adjustments for transfers between the taxpayer and the QBU or amongst QBUs of the taxpayer.

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10 Section 985(b)(1)(B); Treas. Reg. § 1.985-1(c).

11 Section 988(c)(1); Treas. Reg. § 1.988-1(a).

12 Treas. Reg. § 1.987-1(b)(2).

The first two rules are straightforward; the third rule less so. The third rule clearly contemplates that "remittances" trigger recognition of section 987 gain or loss but it does not delineate precisely how.[13] The House committee report accompanying the TRA stated that a remittance should trigger "gains and losses inherent in functional currency or other property remitted to the home office" in a manner that would generally treat activities conducted in branch form similar to those conducted through a subsidiary.[14] The Conference report was more specific: "any remittance of property (not just currency) will trigger exchange gain or loss inherent in accumulated earnings or branch capital."[15]

1. The 1991 Proposed Regulations

In 1991, the IRS and Treasury released proposed regulations under section 987 (the "***1991 Proposed Regulations***").[16] Under the 1991 Proposed Regulations, the taxable income of a QBU branch[17] was to be determined using a "profit and loss" method. The proposed regulations required the taxpayer to start with the non-tax profit and loss statement in the functional currency of the QBU branch, to make book-to-tax adjustments with respect to this statement in the functional currency of the QBU branch, and then to translate the taxable income at the weighted average exchange rate for the year.[18]

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

14 H.R. REP. NO. 99-426, at 469-70 (1985). *See also* S. REP. NO. 99-313, at 455 (1986).

15 CONF. REP. NO. 99-841, Vol. II, at II-675 (1986).

16 Notice of Proposed Rulemaking, Calculation of Currency Gain or Loss on Transfers from Qualified Business Unit Branches Using the Profit and Loss Method of Accounting, 56 Fed. Reg. 48457 (Sept. 25, 1991) [hereinafter 1991 Prop. Reg.].

17 The 1991 Proposed Regulations use the term "QBU branch" to describe a QBU that operates in a functional currency that is different from that of the owner.

18 1991 Prop. Reg. § 1.987-1(b).

a. Determining unrealized section 987 gain or loss

The 1991 Proposed Regulations provided rules for determining the portion of economic gain or loss from the taxpayer's net investment in the QBU branch attributable to changes in exchange rates as well as rules governing the timing of section 987 gain or loss recognition. Those rules required the owner to track two accounts with respect to each QBU branch—a "basis pool" and an "equity pool." The basis pool was denominated in the owner's functional currency and measured the net tax basis of the owner's investment in the QBU branch.[19] The equity pool was denominated in the QBU branch's functional currency and measured the same amount (the owner's net investment in the QBU branch) in the QBU branch's functional currency.[20] At any given time, the unrealized section 987 gain or loss attributable to the owner's investment in the QBU branch is simply the difference between the value of the equity pool translated into the owner's functional currency at the current spot rate and the basis pool.

The 1991 Proposed Regulations increase the equity and basis pool balances by the amount of property transferred from the owner to a QBU branch, including contributions of capital, and by the amount of taxable income arising from the QBU branch's activities.[21] The equity and basis pool balances are decreased by the amount of property transferred from the QBU branch to the owner and for any taxable loss arising from the QBU branch's

19 1991 Prop. Reg. § 1.987-2(c)(2).

20 1991 Prop. Reg. § 1.987-2(c)(1).

21 1991 Prop. Reg. §§ 1.987-2(c)(1)(ii) and (c)(2)(ii).

activities.[22] These adjustments reflect an increase or decrease in the owner's net investment in the QBU branch.

b. Realization and recognition of section 987 gain or loss

Under the 1991 Proposed Regulations, the owner realizes and recognizes a section 987 gain or loss on a remittance from or a termination of the QBU branch.[23] A remittance is a transfer of property from the QBU branch to the owner to the extent that the transfers during the year did not exceed the positive year-end balance of the equity pool.[24] If the transfer is a remittance, the transfer triggers realization and recognition of a portion of the unrealized section 987 gain or loss and a corresponding adjustment to the pool balances.

The amount of section 987 gain or loss realized and recognized is equal to the amount of remittance translated at the spot rate on the date of remittance less the portion of the basis pool remitted.[25]

1. Earnings Only Approach under Notice 2000-20

In 2000, the IRS and Treasury issued Notice 2000-20,[26] which notified taxpayers that the 1991 Proposed Regulations were being reevaluated and articulated a potential alternative that would compute section 987 gain or loss on remittances of the QBU branch's earnings only—the "earnings only" method. Under the "earnings only" method, an owner would maintain equity and basis pools as described above but only with respect to its earnings. In other words,

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22 1991 Prop. Reg. § 1.987-2(c)(1)(iii) and (c)(2)(iii).

23 1991 Prop. Reg. § 1.987-2(a)(1).

24 1991 Prop. Reg. § 1.987-2(b)(4).

25 1991 Prop. Reg. § 1.987-2(d)(1).

26 2001-1 C.B. 851.

transfers of property from the owner to the QBU branch would not increase the pools and transfers of property in excess of earnings would not decrease the pools.

2. The 2006 and 2016 Regulations

a. FEEP

In the preamble to the regulations proposed in 2006 (the "***2006 Proposed Regulations***") (and in Notice 2000-20), the IRS and Treasury articulated two fundamental concerns: one related to the "base" of assets and liabilities that give rise to section 987 gain or loss; the other related to the use of remittances to determine the "timing" of section 987 gain or loss recognition.[27] To address these concerns, the IRS issued the 2006 Proposed Regulations that were later finalized in 2016 (the "***2016 Regulations***").[28] These regulations set forth a different approach to section 987, which was described in the preamble to the 2006 Proposed Regulations as the "foreign exchange exposure pool" method ("***FEEP***").

To address the fundamental concern with the "base" of assets that give rise to unrealized section 987 gain or loss, the 2016 Regulations classify each asset (and liability) on a QBU's balance sheet as either a "marked item" or an "historic item." Marked items are assets or liabilities denominated in the functional currency of the QBU and that are perceived to change in value based on changes in exchange rates. Marked items are largely limited to assets or liabilities that if held (or entered into) by the owner directly would constitute section 988 transactions—nonfunctional currency, debt assets or liabilities denominated in a nonfunctional

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27 Withdrawal of Notice of Proposed Rulemaking, Notice of Proposed Rulemaking and Notice of Public Hearing, Income and Currency Gain or Loss With Respect to a Section 987 QBU, 71 Fed. Reg. 52876 (Sept. 7, 2006).

28 Final Regulations, Income and Currency Gain or Loss With Respect to a Section 987 QBU, 81 Fed. Reg. 88806 (Dec. 8, 2016).

currency, and derivatives of nonfunctional currency or nonfunctional currency-denominated debt.[29] Historic items are assets and liabilities that are not marked items and thus include capital assets, section 1231 property, inventory and all other items of non-currency property.[30] The preamble to the 2006 Proposed Regulations explains that the IRS views historic items as assets (or liabilities) whose value measured in the owner's functional currency does not change as currency exchange rates change, even where the historic item is immobilized in a nonfunctional currency economic environment.[31] To ensure that historic items do not contribute to unrealized section 987 gain or loss, the 2016 Regulations require the taxpayer to account for the historic item for tax purposes as if it had a functional currency basis, effectively excluding it from the "base" of items that give rise to unrealized section 987 gain or loss.[32] The 2016 Regulations continue to recognize section 987 gain and loss on a proportionate basis. Specifically, a remittance (determined on the last day of a taxable year) triggers a portion (a percentage between zero and 100 percent) of the unrealized section 987 gain or loss on that date. The percentage is the ratio of the amount of the remittance and the aggregate adjusted basis of the QBU's gross assets (both determined as of the last day of the taxable year).[33]

The 2016 Regulations also directly address the IRS's earlier articulated concerns regarding the timing of section 987 gain or loss recognition. Most directly, the regulations tightened the definition of "remittance." Under the 1991 Proposed Regulations, there was no requirement that near-in-time contributions and remittances be netted. Thus, it was possible (as

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[29] Treas. Reg. § 1.987-1(d).

[30] Treas. Reg. § 1.987-1(e).

[31] 71 Fed. Reg. at 52880.

[32] Treas. Reg. §§ 1.987-1(c)(3)(i) and 1.987-2(d)(2).

[33] Treas. Reg. § 1.987-5(a).

was noted in the preamble to the 2006 Proposed Regulations)[34] for taxpayers to selectively realize and recognize section 987 gain or loss by remitting an asset and, shortly thereafter, recontributing it. The 2016 Regulations largely prevent this by requiring all transfers to and from the QBU over a calendar year to be netted in order to determine whether there has been a remittance for the year.[35]

b. Transition Methods

The 2006 Proposed Regulations proposed two alternative transition rules—the "deferral" method" and the "fresh start" method. Under the deferral method, immediately before the transition date, all QBUs would be deemed to terminate for purposes of measuring unrealized section 987 gain or loss on a QBU-by-QBU basis as of the transition date. The section 987 gain or loss so determined was then treated as net unrecognized section 987 gain or loss of the new QBU beginning immediately after the transition date. To ensure that lifetime income was not duplicated or omitted, the deferral rule then required the "historic rate" to be set in a manner that preserved the transition-date unrecognized gain or loss in the asset. In other words, the functional currency basis of the asset was to be set such that the unrealized economic gain or loss with respect to the asset equaled the sum of (1) the portion of unrealized section 987 gain or loss attributable to the asset and (2) unrealized gain or loss reflected in the functional currency basis of the asset. The fresh start method, by contrast, was both more straightforward and less economically accurate. Under this method, the unrealized section 987 gain or loss as of the date of termination was ignored. The taxpayer would start each new QBU with no beginning unrealized section 987 gain or loss. In addition, the taxpayer would translate

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34 71 Fed. Reg. at 52887.

35 Treas. Reg. § 1.987-5(c)(1).

asset basis (and liability amounts) at the historic exchange rate for the date the asset was acquired (or the liability) was entered into. This method, by definition, results in some items of economic gain or loss being permanently omitted. For example, consider a QBU (applying the 1991 Proposed Regulations) of a dollar functional currency owner that acquired an asset at the time the QBU was formed. If the dollar strengthens against the QBU's functional currency, the unrealized section 987 item attributable to the asset would be a loss. Under the fresh start transition, the unrealized section 987 loss attributable to that asset (indeed attributable to all assets) would disappear. However, the requirement that the new QBU determine its initial basis by reference to the historic exchange rate at the time that assets were acquired would effectively restore the loss if such asset were still on hand. If, on the other hand, the original asset had been sold after the strengthening of the dollar and a new asset acquired with the proceeds, the unrealized section 987 loss eliminated upon the fresh start would only be restored to the extent it was driven by a strengthening of the dollar after its acquisition. The portion of the unrealized section 987 loss attributable to the strengthening of the dollar while the original asset was on hand was forever lost.

The 2016 Regulations eliminated the deferral regime, making the fresh start rule the exclusive rule.

3. *The Proposed Regulations*

a. *FEEP*

The Proposed Regulations classify each asset (and liability) on a QBU's balance sheet as either a "marked item" or an "historic item." Marked items are assets or liabilities denominated in the functional currency of the QBU and that are perceived to change in value based on changes in exchange rates. Marked items are largely limited to assets or liabilities that if held (or entered into) by the owner directly would constitute section 988 transactions.[36] Historic items are assets and liabilities that are not marked items and thus include capital assets, section 1231 property, inventory and all other items of non-currency property.[37]

To ensure that historic items do not contribute to unrealized section 987 gain or loss, the Proposed Regulations require the taxpayer to track the historic item's basis in the functional currency of the QBU and translate it into the owner's functional currency using the "historic rate" for the item.[38] The historic rate is generally the average exchange rate for the year in which the item was acquired.[39]

In addition, the Proposed Regulations continue to exclude certain assets and liabilities from a QBU's balance sheet for section 987 purposes. Stock in lower-tier entities, partnership interests, and borrowings associated with these assets are not attributable to a QBU[40] because they are generally not fundamental to a trade or business.

The Proposed Regulations continue to require all transfers to and from the QBU over a taxable year to be netted in order to determine whether there has been a

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[36] Prop. Reg. § 1.987-1(d).

[37] Prop. Reg. § 1.987-1(e).

[38] Prop. Reg. §1.987-4(e)(2)(ii).

[39] Prop. Reg. §1.987-1(c)(3).

[40] Prop. Reg. §1.987-2(b)(2).

remittance for the year.[41] The Proposed Regulations propose a new transition rule that is discussed in more detail later on.

b. The Current Rate Election

To alleviate the compliance burden associated with the FEEP method's treatment of historic items, the Proposed Regulations provide an election to treat all items that are properly reflected on the books and records of a section 987 QBU as marked items (referred to as a "current rate election"). If a current rate election is made, all items of income, gain, deduction, and loss with respect to a section 987 QBU would be translated at the yearly average exchange rate for the current taxable year for purposes of computing section 987 taxable income or loss. In addition, all items of a section 987 QBU would be translated at the year-end spot rate for purposes of computing section 987 gain or loss.

However, according to the Preamble to the Proposed Regulations, "because taxpayers that make a current rate election are expected to have substantial pools of net unrecognized section 987 gain or loss, special rules are needed to prevent the selective recognition of losses." As a result, if a current rate election is in effect, the Proposed Regulations generally would suspend the recognition of section 987 loss until a taxable year in which an equal or greater amount of section 987 gain is recognized of the same source and character (*i.e.*, assigned to the same GILTI or subpart F income group) or until the occurrence of certain recognition events.

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[41] Prop. Reg. § 1.987-5(c)(1).

IV. Detailed Discussion of Recommendations

A. Lookback Rule

The Proposed Regulations provide that a section 987 loss recognized in a year in which a current rate election is in effect will only be recognized to the extent of section 987 gain of the same source and character recognized in the same year and any excess loss will be deferred and become a "suspended section 987 loss."[42] A suspended section 987 loss will only be recognized to the extent of section 987 gain of the same source and character in a later taxable year (referred to in the Proposed Regulations as the "loss-to-the-extent-of-gain rule").[43]

The Preamble states that a lookback rule, under which a section 987 loss could be recognized to the extent that section 987 gain was recognized in a prior taxable year, was considered. However, the Proposed Regulations do not include such a lookback rule because of concerns that "a lookback rule would permit taxpayers to selectively trigger section 987 gain in taxable years in which such gain would not give rise to additional U.S. tax."[44] As examples of gain that does not give rise to additional U.S. tax, the Preamble offers gain that is offset by losses or that is offset with foreign tax credits.[45] The IRS and Treasury requested comments on how a lookback rule could be implemented in a manner that prevents section 987 gain that has "no net effect on U.S. tax" from releasing section 987 loss that reduces U.S. tax.

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42 Prop. Reg. § 1.987-11(c).

43 Prop. Reg. § 1.987-11(e)(2). The source and character are determined under the rules of Prop. Reg. § 1.987-6(b)(2)(i). Prop. Reg. § 1.987-11(f)(1).

44 88 Fed. Reg. at 78139.

45 *Id*.

In our 2018 Report, we recommended the adoption of a lookback rule, and we continue to believe that is the correct approach, especially in the context of section 987 gain recognized under the method of the Proposed Regulations. First, where the section 987 gain recognized in a previous year was not offset by a loss carryforward or by a foreign tax credit, there does not appear to be any reason that a lookback rule should not be allowed. Even in the context of previous section 987 gains that were offset by a loss carryforward or foreign tax credit, with respect to which the IRS and Treasury have expressed concerns, we do not believe that gain offset by losses and foreign tax credits has "no net effect on U.S. tax."[46] The use of such losses and foreign tax credits has a net effect on U.S. tax because it reduces available tax attributes that could have been used to offset other gain. There is no abuse inherent in timing section 987 gain so as to use such losses or credits against such gain, even where such losses or credits might otherwise expire unused.[47] The Code provides many restrictions on when and how losses and credits can be utilized to reduce U.S. tax, and we do not believe that additional restrictions are necessary in this context, particularly when the section 987 gain and loss need to be matched by source and group. We are of the understanding that "remittances" that trigger section 987 gain have real economic impact and cannot be easily unwound. Further, where a "remittance" does not have a real economic consequence, we believe the appropriate remedy is

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[46] However, a minority supported the view that there is some potential for abuse associated with recognition of gains realized in respect of remittances that did not have any actual economic effect and that therefore the IRS and Treasury should consider anti-abuse rules that would prevent the use of gains from transactions that have no substance. In particular, the IRS and Treasury may want to consider whether certain leveraged remittances may not have the economic effect of contracting the assets of the section 987 QBU making such remittance and whether a distinction should be made between recourse debt and nonrecourse debt incurred to make such a remittance. We note that concerns with respect to the economic effect of a remittance are not specific to the context of recognizing a suspended section 987 loss and if there are concerns with respect to the economic effect of distributions treated as remittances, such concerns should be addressed more broadly.

[47] While the IRS and Treasury's concern could have some salience in the context of (i) foreign tax credits at the end of their carryforward period under Section 904(c) or (ii) pre-2018 net operating losses at the end of their twenty-year carryforward period, post-2017 net operating losses can be carried forward indefinitely. Section 172(b)(1)(1)(A)(ii). Therefore, their use against section 987 gain cannot fairly be characterized as not having a net effect on U.S. tax.

to disregard the "remittance" and thus prevent any section 987 gain from being recognized in that situation.[48]

Furthermore, the loss-to-the-extent-of-gain rule could in certain circumstances lead to an effective disallowance of a suspended section 987 loss. For example, if a foreign corporation with a suspended section 987 loss merges into a domestic corporation, the domestic corporation will not succeed to the suspended section 987 loss and such suspended section 987 loss will be eliminated.[49] While we do not object to certain situations where a suspended section 987 loss might disappear, it seems to us to be a particularly harsh outcome where prior section 987 gains in the same grouping have been recognized.

We also do not believe that there is a particular reason that a lookback rule should not be applied to pretransition gain. First, pretransition gain that was not recognized in a year prior to the transition date is treated as net unrecognized section 987 gain;[50] thus, even under the Proposed Regulations, such gain can be reduced by future fluctuations in currencies. In addition, any section 987 gain that was recognized in a prior year would have been included in taxable income at such time and would not have been recognized in anticipation of using losses under provisions first proposed in the Proposed Regulations. Moreover, the current rate election is intended to approximate the result that would be reached under the 1991 Proposed Regulation.

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48 As noted in the preamble to the 2006 Proposed Regulations, the annual netting of contributions and distributions under Treasury Regulations Section 1.987-5(c) to determine the amount of a remittance is in part intended to ensure that such remittances have economic effect. 71 Fed. Reg. at 52887. We note in this regard that a better mechanism for ensuring that remittances have economic effect might be for taxpayers to be required to take into account any contributions and distributions made within 12 months of each other, which would limit the ability for taxpayers to circumvent the netting rule by making contributions and distributions close in time but crossing a tax year. However, a more fulsome analysis of remittances is beyond the scope of this Report.

49 Prop. Reg. § 1.987-13(g).

50 Prop. Reg. § 1.987-10(e)(5)(i)(A).

Therefore, taxpayers that have a current rate election in place as of the transition date and whose pretransition method of applying section 987 was that of the 1991 Proposed Regulations would be expected to have pretransition gain or loss in an amount roughly equal to the amount of net unrecognized section 987 gain or loss under a current rate election. Accordingly, there does not seem to be any reason for such pretransition gain to be treated differently than section 987 gain recognized under the Proposed Regulations. However, to the extent that the IRS and Treasury have concerns about pretransition methodologies of which we are unaware, we believe rules preventing a lookback should apply only to recognized pretransition section 987 gain and not to section 987 gain recognized under the Proposed Regulations.

B. Pretransition Loss

In response to comments from taxpayers that the fresh start transition method would be administratively burdensome and would result in the elimination of some section 987 losses,[51] the Proposed Regulations replaced the fresh start transition method with a new approach.[52] Under the approach of the Proposed Regulations, the section 987 gain or loss that would have been recognized if the section 987 QBU terminated on the day prior to the transition date is computed and recognized as "pretransition gain or loss."[53] For taxpayers that used an "eligible pretransition method" in applying section 987 prior to the transition date, that

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[51] *See* 2018 Report at 27-28.

[52] 88 Fed. Reg. at 78150.

[53] Prop. Reg. § 1.987-10(e)(1).

computation is done on the basis of that method.[54] Otherwise, the taxpayer must use a prescribed method set forth in the Proposed Regulations.[55]

The Proposed Regulations provide that pretransition gain is treated as "net unrecognized section 987 gain" and pretransition loss is treated as suspended section 987 loss.[56] The Preamble provides that the purpose of this rule is to prevent taxpayers from selectively recognizing pretransition loss, which may have arisen on "historic" assets, while deferring pretransition gain until a remittance.[57]

We agree that taxpayers should not be allowed to selectively recognize pretransition losses while deferring pretransition gain until a remittance. However, we do not view that as a reason for pretransition losses to be automatically recognized and suspended. We believe pretransition loss can be treated as unrecognized section 987 loss, similar to the treatment of pretransition gain, and become suspended section 987 loss upon a recognition event.

We acknowledge that such a rule could cause a mismatch between the grouping of the pretransition loss and the grouping of the gain that would erode such loss if the assets of a section 987 QBU were to shift following the transition and prior to the recognition of the pretransition loss.[58] Generally, the grouping of section 987 gain or loss is determined in the

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54 Prop. Reg. § 1.987-10(e)(2).

55 Prop. Reg. § 1.987-10(e)(3).

56 Prop. Reg. § 1.987-10(e)(5)(i).

57 88 Fed. Reg. at 78150.

58 Although the quantum of section 987 gain or loss will likely be considerably reduced for taxpayers not making the current rate election, the rules regarding pretransition loss under the Proposed Regulations would not reduce the extent to which pretransition loss can be used against future section 987 gain if there is no change to the assets of the section 987 QBU. If the assets of the section 987 QBU do not change following the transition, the grouping of the pretransition loss and the future section 987 gain would likely be identical. Accordingly, the effect of treating pretransition loss as recognized but suspended occurs when

taxable year in which it is recognized or the taxable year in which section 987 loss becomes a suspended section 987 loss.[59] Therefore, under the rule of the Proposed Regulations, the grouping of pretransition loss is determined as of the day before the transition date, which is the date that it becomes a suspended section 987 loss under the Proposed Regulations.[60] Accordingly, if pretransition loss were to be treated as net unrecognized section 987 loss, such pretransition loss would reduce future net unrecognized section 987 gain on a pooled basis, *i.e.*, without regard to the source and grouping of the net unrecognized section 987 gain. However, we believe such a result is acceptable.

First, section 987 gain or loss under the Proposed Regulations is grouped by reference to all assets of the section 987 QBU, including historic assets. Therefore, it would not seem that a rule providing that pretransition loss is only grouped when it would otherwise be recognized and that it reduces net unrecognized section 987 gain on a pooled basis prior to such time causes any significant distortion beyond the distortion inherent in applying an asset method in the first place. The possibility of distortion would be further lessened if our recommendation below, that the rule treating any income assigned to a subpart F group as attributable to section 988 transactions be eliminated, is adopted.

Second, we see no reason to treat pretransition loss differently from pretransition gain for this purpose. Any concern regarding mismatched grouping caused by treating pretransition loss as net unrecognized section 987 loss is equally applicable to treating pretransition gain as net unrecognized section 987 gain. We would not advocate a rule providing

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the assets of the section 987 QBU change between the transition date and the recognition of future section 987 gain.

59 Prop. Reg. § 1.987-6(b)(1)(i)-(ii).

60 Prop. Reg. § 1.987-10(e)(1).

that pretransition gain be treated as "suspended section 987 gain" and that an additional rule limiting the recognition of pretransition gain to the extent of previously recognized section 987 loss in the same grouping be adopted, as such an approach appears unnecessarily complicated. Accordingly, we recommend that pretransition gain or loss be treated as net unrecognized section 987 gain or loss and that pretransition losses be treated as suspended section 987 loss when recognized (if not otherwise eliminated by movements in currency rates).

C. Suspended Section 987 Loss: Section 331 Liquidations

The general rule under the Proposed Regulations is that if a section 987 QBU terminates with no successor, the owner of the section 987 QBU recognizes the cumulative suspended section 987 loss that would not otherwise be recognized under the loss-to-the-extent-of-gain rule.[61] The Preamble explains that the IRS and Treasury expect that a taxpayer would be less likely to sell or wind up the trade or business of a section 987 QBU for the purpose of selectively recognizing section 987 losses and therefore it is not necessary to limit the recognition of suspended section 987 losses following such an event.[62] However, the Proposed Regulations provide that if a suspended loss QBU owner terminates upon a section 331 liquidation, any suspended section 987 loss not recognized after the application of the loss-to-the-extent-of-gain rule cannot be recognized and is eliminated.[63] The Preamble explains that the reason for this exception to the general rule is to prevent taxpayers from entering into section 331 transactions in order to trigger the recognition of suspended section 987 loss.[64] The Preamble

61 Prop. Reg. § 1.987-13(b)(2).

62 88 Fed. Reg. at 78140.

63 Prop. Reg. § 1.987-13(f).

64 88 Fed. Reg. at 78140.

provides a specific example of an upper-tier CFC that transfers the assets and liabilities of its section 987 QBU to a lower-tier CFC before liquidating in a section 331 transaction.[65]

We agree with the general principle that taxpayers should not be able to enter into section 331 transaction in order to trigger the recognition of suspended section 987 loss when the business of the QBU otherwise continues. However, we think this proposed rule can be refined to the extent the concern does not apply to gains actually recognized by the liquidating corporation under section 336. While such recognized gains may increase depreciation or amortization going forward, we believe that a terminating corporation ought to be able to utilize its own suspended section 987 losses in this way. The basis of the QBU going forward reflects such losses, and we believe that the liquidating corporation should be allowed to use such losses even if there are future benefits to a stepped-up basis. Therefore, we propose that the Proposed Regulations should be revised to provide that if a suspended loss QBU owner ceases to exist as a result of a section 331 liquidation, suspended section 987 loss of such QBU owner should be allowed to be recognized only to the extent of gain recognized by such suspended loss QBU owner in the section 331 liquidation and that any remaining suspended section 987 loss that is not recognized after the application of the loss-to-the-extent-of-gain rule cannot be recognized and is eliminated.

D. Subpart F Allocations

The Proposed Regulations retain the rule that the character of section 987 gain or loss is determined in the year of remittance using the asset method of Treasury Regulations

[65] *Id*.

Sections 1.861–9(g) and 1.861–9T(g).[66] The Proposed Regulations also retain the rule providing that section 987 gain or loss that is assigned to a subpart F income group is treated as foreign currency gain or loss attributable to section 988 transactions not directly related to the business needs of the CFC, meaning that such section 987 gain or loss would be passive subpart F income (the "***section 988 allocation rule***").[67] The Preamble requests comments as to whether the section 988 allocation rule should be eliminated and section 987 gain or loss should be characterized by reference to subpart F income groups or whether the section 988 allocation rule should be retained generally but a different rule should be applied to taxpayers that make a current rate election.[68] The reason for applying a different rule to taxpayers that make a current rate election is because, in contrast to taxpayers applying the default FEEP method under the Proposed Regulations, taxpayers that make a current rate election may have section 987 gain or loss with respect to assets that would not generate section 988 gain or loss in the hands of the owner.[69]

We believe that the section 988 allocation rule should be eliminated for the following reasons. As an initial matter, it is unclear why the character of section 987 gain or loss under the Proposed Regulations is allocated using the asset method of Treasury Regulations Sections 1.861–9(g) and 1.861–9T(g). Under the method of the 1991 Proposed Regulations, pursuant to which section 987 gain or loss could arise with respect to all assets in a QBU, it was logical to allocate income on the basis of the assets of the QBU. However, under the FEEP

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66 Prop. Reg. § 1.987-6(b)(2)(i)(A).

67 Prop. Reg. § 1.987-6(b)(2)(i)(C). Under the asset method of Treas. Reg. § 1.861-9 and Temp. Treas. Reg. § 1.861-9T, assets are first placed into statutory groupings based on the kind of income they generate. Section 987 gain or loss is then allocated based on the U.S. tax basis of those assets. Under the business needs exception of Treas. Reg. § 1.954-2(g)(2)(ii), foreign currency gain or loss directly related to the business needs of the CFC is excluded from foreign personal holding company income.

68 88 Fed. Reg. at 78144.

69 *Id*.

method of the Proposed Regulations, pursuant to which only marked items (*i.e.*, items that would give rise to section 988 income if entered into directly by the owner of the QBU) give rise to section 987 gain or loss, there does not appear to be a reason to determine the character of section 987 gain or loss on the basis of all of the QBU's assets. It would seem far more logical to treat all section 987 gain or loss as gain or loss that is attributable to section 988 transactions (based on the definition of marked assets) and to allow for the application of the business needs exception.[70] Such an approach would provide a parity of outcomes between section 987 gain or loss at a QBU and the corresponding section 988 gain or loss that would have been recognized if the owner had entered into a section 988 transaction with respect to the marked item, which appears to be the intended outcome under the Proposed Regulations.

While not completely clear from the relevant preambles, it seems that the reason for applying the asset method may be that the IRS and Treasury believe that such an approach is required under section 987(3)(B), which requires that section 987 gain or loss must be sourced by reference to the source of the income giving rise to post-1986 accumulated earnings.[71] If that is the case, however, we see no reason why the same logic should not apply with respect to the allocation of section 987 gain or loss that is assigned to a subpart F income group, and therefore it appears inconsistent to require section 987 gain or loss that is assigned to a subpart F income group to be treated solely as foreign currency gain or loss attributable to section 988 transactions. We believe that such a requirement has a distortive effect and is inconsistent with a general asset-based approach.

70 Under such an approach, it would still be necessary to use the asset method for purposes of sourcing section 987 gain or loss. However, it would be more logical to apply the asset method for such purpose solely on the basis of the marked assets, which are the assets giving rise to the section 987 gain or loss.

71 *See* 71 Fed. Reg. at 52888.

In addition, as the IRS and Treasury acknowledge in the Preamble, the section 988 allocation rule should not apply to taxpayers that make a current rate election. The IRS and Treasury presumably believe that taxpayers making a current rate election should characterize section 987 gain or loss by reference to subpart F income groups. Therefore, the elimination of this requirement for all taxpayers would have the added benefit of reducing administrative complexity by applying the same grouping rules with respect to all taxpayers rather than the addition of separate rules for taxpayers making the current rate election.

If the IRS and Treasury choose not to accept our recommendation to eliminate this rule generally, we recommend that the rule be eliminated for taxpayers that make a current rate election for the reasons acknowledged in the Preamble; because section 987 gain or loss can arise with respect to assets that would not generate section 988 gain or loss in the hands of the owner.

Although similar reasoning would seem to apply to pretransition loss, which can also arise with respect to assets that would not generate section 988 gain or loss in the hands of the owner, we do not recommend that the rule be eliminated for purposes of characterizing pretransition gain or loss if it is not eliminated more generally. If pretransition loss were assigned to subpart F groups, but the general rule treating any income assigned to a subpart F group as attributable to section 988 transactions is retained, the portion of the pretransition loss assigned to other subpart F groups would effectively be disallowed for taxpayers that do not make a current rate election because there would never be section 987 gain within such grouping to which the loss-to-the-extent-of-gain rule could apply.

E. CAMT

As noted in the Preamble, the rules for taking section 987 gain or loss into account as taxable income differ significantly from U.S. generally accepted accounting principles ("GAAP") relating to foreign currency translation gain or loss.[72] Accordingly, we recommend that the IRS and Treasury consider the impact of foreign currency translation gain or loss on the CAMT regime.

[72] 88 Fed. Reg. at 78137.