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Report No. 1535
November 11, 2026

The Honorable Scott Bessent
Secretary of the Department of the Treasury, and Acting Commissioner of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Kevin Salinger
Acting Assistant Secretary (Tax Policy) of the Department of the Treasury, and Acting Chief Counsel of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: NYSBA Tax Section Report No. 1535 – Report on Final and Proposed Regulations under Section 987

Dear Secretary Bessent and Acting Assistant Secretary Salinger:

Please see attached Report No. 1535 of the Tax Section of the New York State Bar Association (the "Report") commenting on the notice of proposed rulemaking published on August 14, 2026 (the "2026 Proposed Regulations"), and certain aspects of the final regulations issued in 2024 (the "2024 Final Regulations"), under section 987 of the Internal Revenue Code. The Report addresses the foreign-currency rules applicable to qualified business units, with particular attention to the proposed election to exempt controlled foreign corporations ("CFCs") and partnerships owned by CFCs from the application of section 987(3).

With respect to the 2026 Proposed Regulations, consistent with our recommendation in Report No. 1526 (the "Prior Report"), the Report recommends that, in an inbound asset reorganization or liquidation involving a CFC for which the proposed exemption election has been made, unrecognized section 987 gain generally be addressed through a reduction in the basis of the imported assets rather than immediate gain

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recognition. This Report goes beyond the Prior Report in suggesting a potential mechanism for preventing the basis-reduction rule from creating opportunities for abuse or unintended consequences associated with the conversion of section 987 foreign currency gain into gain of a different character or source. While generally supporting the "acquirer's-elections-control" rule for M&A transactions directly or indirectly involving CFCs, the Report also recommends modifications or exceptions to the rule in certain circumstances and addresses a related question of what should happen when a CFC departs from an exempt group that has unamortized pre-election or pre-transition section 987 gain or loss. In addition, the Report addresses basis adjustments for exempt partnerships including rules (i) potentially accelerating unamortized pre-election partnership section 987 gain or loss and related basis adjustments and (ii) governing interactions with sections 734(b) and 743(b).

The Report also recommends targeted guidance concerning partnerships under the 2024 Final Regulations. In particular, it proposes an elective, simplified application of section 987(3) for certain partnerships using an equity and basis pool method; an election out of section 987(3) for certain partnerships for which capital is not a material income-producing factor; and clarification of the elections and reporting requirements applicable when a partnership adopts a reasonable method under the regulations.

We appreciate the opportunity to comment on these important issues and thank Treasury and the IRS for considering the views of the Tax Section. If you have any questions or would like to discuss any aspect of the Report, please do not hesitate to contact us. We would be pleased to assist in any way.

Respectfully submitted,



Lawrence M. Garrett
Chair

Enclosure

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Report No. 1535

New York State Bar Association Tax Section

Report on Final and Proposed Regulations Under Section 987

November 11, 2026

Opinions expressed are those of the Tax Section and do not represent those of the New York State Bar Association unless and until they have been adopted by its House of Delegates or Executive Committee.

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I. Introduction

This report (this "**Report**")[1] of the Tax Section of the New York State Bar Association (the "**Tax Section**") addresses a notice of proposed rulemaking published August 14, 2026 (the "**2026 Proposed Regulations**")[2] and aspects of final regulations issued effective December 10, 2024 (the "**2024 Final Regulations**") by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") under Section 987 of the Internal Revenue Code.[3] These Treasury Regulations generally govern the foreign currency consequences associated with the ownership of a qualified business unit ("**QBU**") the functional currency of which differs from the functional currency of the QBU's owner (a "**Section 987 QBU**"). We have previously provided comments on the regulations proposed in 2006;[4] on Notice 2017-57, regarding changes to the regulations finalized in 2016;[5] on regulations proposed in 2023;[6] and on select topics in Notice 2026-17.[7]

Part II of this Report summarizes our principal recommendations for guidance from the IRS and Treasury. Part III provides general background on the relevant aspects of Section 987 and the related regulations. Part IV provides a discussion of our comments and recommendations for guidance related to the 2026 Proposed Regulations. Part V provides a discussion of our comments and recommendations related to the application of the 2024 Final Regulations by entities classified as partnerships for U.S. federal income tax purposes.

II. Summary of Recommendations

We appreciate that Treasury and the IRS face a difficult task in promulgating rules for implementing Section 987, especially Section 987(3). The task is even more difficult in adopting

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[1] The principal authors of this report are Lee Holt, Rebecca Lee, and Jennifer Ray. Substantial drafting assistance was provided by Brian Stevens. Helpful comments were received from Larry Garrett, Robert Kantowitz, Mike Kohler, Stuart Rosow, Michael Schler, and Miran Vila. This Report reflects solely the views of the Tax Section and not those of the New York State Bar Association Executive Committee or its House of Delegates.

[2] 91 FR 52,553–52,576.

[3] Unless otherwise noted, references herein to "**Section**" are to sections of the Internal Revenue Code of 1986 (the "**Code**"), as amended, references herein to "**Prop. Treas. Regs. §**" are to sections of proposed regulations ("**Proposed Regulations**") promulgated under the Code, and references herein to "Treas. Regs. §" are to sections of the regulations (the "**Regulations**") promulgated under the Code.

[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. 22, 2018).

[6] New York State Bar Ass'n Tax Section, *Report on Proposed Regulations Under Section 987* (Report No. 1488, Feb. 12, 2024).

[7] New York State Bar Ass'n Tax Section, *Report on Notice 2026-17: Modification to Certain Rules Under Section 987* (Report No. 1526, Apr. 26, 2026).

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rules for partnerships. We propose the following recommendations with respect to the 2026 Proposed Regulations and with respect to certain aspects of the 2024 Final Regulations relating to partnerships:

Recommendations related to the 2026 Proposed Regulations

1. Inbound Transactions

In the case of an inbound asset reorganization or liquidation of a CFC (as defined below) for which the CFC Election (as defined below) has been made (an "Inbound Transaction"), rather than immediately triggering unrealized Section 987 gain, the basis of assets received from the CFC should be reduced to account for the Section 987 gain (but not loss) that would have been taken into account by the CFC had it not made the CFC Election. If this recommendation is adopted, we suggest considering additional rules to prevent abuse and/or unintended consequences, including, rules to prevent the basis-reduction mechanics from changing the source or character of income attributable to foreign currency fluctuations.

2. M&A Transactions

a. If an acquisition would require a change in the Section 987 election status of target QBUs, the target QBUs should retain their pre-acquisition election status through the end of the target CFC's taxable year in which the acquisition occurs, including any short taxable year resulting from a closing of the CFC's taxable year or a change in taxable year under Section 898. The target QBUs should conform to the acquirer's election status beginning with the following taxable year.
b. Treasury and the IRS should clarify that, where the target consolidated group continues by reason of Treas. Reg. § 1.1502-75(d)(3) applying, the target consolidated group should be treated as the acquirer for purposes of determining the controlling Section 987 election status (i.e., so that the acquiring group's members must conform their Section 987 elections, including the CFC Election, to the target group's election status.
c. Treasury and the IRS should consider whether an exception to the acquirer-elections-control rule would be appropriate where the target's Section 987 QBUs represent a specified majority of the combined Section 987 QBU gross assets.
d. Treasury and the IRS should consider providing additional rules addressing the treatment of unamortized pre-transition and pre-election Section 987 gain or loss when ownership of a CFC changes. One possible approach would be to permit such amounts to remain with the historic U.S. shareholder and continue to be recognized over the balance of the 120-month amortization period, rather than carrying over to the acquiring group. This approach may provide symmetrical treatment of gains and losses and mitigate loss-trafficking concerns. We recognize, however, that retaining these amounts with the historic U.S. shareholder could raise significant administrative and technical issues, including the treatment of associated foreign tax credits and the computation of the Section 250 deduction after the historic U.S. shareholder no longer owns the CFC. These

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and other considerations may make such an approach impractical or require additional rules that could outweigh its potential benefits.

3. Partnerships

    a. Adjustments to CFC basis in partnership with respect to pre-election Section 987 gain or loss

With regard to a CFC's inclusion of pre-election Section 987 gain or loss and adjustment to the basis of a partnership interest, the Regulations generally should operate to prevent duplication of the pre-existing gain or loss. Thus, regardless of whether basis is adjusted immediately or over the amortization period, adjustments to basis or acceleration of pre-existing gain or loss should be required in certain circumstances in which the partner disposes of some or all of the interest in the exempt partnership or receives a distribution from the partnership. To effectuate this, we would recommend one of two possibilities: (1) the CFC's basis in the partnership interest is adjusted over the amortization period as pre-election gain or loss is included, with the basis adjustments (and a corresponding amount of pre-election gain or loss) accelerated if the CFC would otherwise recognize gain or loss on sale of a partnership interest (or as a result of a distribution) that would be a duplication of the pre-election gain or loss or (2) the CFC's basis in the partnership interest is adjusted immediately for the total amount of the unrecognized Section 987 gain or loss, with an acceleration of the pre-election gain to the extent that increased basis would be recovered and an acceleration of the pre-election loss to the extent a portion of the interest is disposed of, in each case before the end of the amortization period. In either case, adjustments would need to be made through tiers of partnerships (if any). We believe that the second approach is likely to be simpler.

    b. Other partnership basis adjustments

In addition to the basis adjustment issues discussed above, Treasury and IRS also should consider the mechanics of adjustments under Sections 734(b) and 743(b) for an exempt partnership owned by an exempt CFC with a different functional currency. Without special rules, currency fluctuations may give rise to potentially inappropriate Section 734(b) or Section 743(b) adjustments.

Recommendations Related to the 2024 Final Regulations and Partnerships

1. Election into simpler application of Section 987(3) for certain partnerships

Treasury and IRS consider allowing a partnership operating solely in one functional currency (whether directly or through one or more QBUs with that functional currency) to elect into a simpler application of Section 987(3), provided that the partners agree to apply an equity and basis pool method with respect to their partnership interests. The equity and basis pool method would be similar to the one described in Notice 2026-17, but with certain modifications specific to partnerships. Upon a sale or disposition, or a distribution resulting in gain recognition, the partner would recognize a proportionate portion of its unrecognized Section 987 gain or loss in the partnership interest and, as a result, recharacterize a portion of the recognized gain or loss as ordinary income or loss. As with the CFC Election, partnerships that make the election would

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still be required to continue to apply the rules of Section 987(1) and (2) for purposes of computing the taxable income of the partnership.

2. Election out of Section 987(3) for certain partnerships for which capital is not a material income-producing factor

Treasury and the IRS should consider guidance providing for certain partnerships for which capital is not a material income-producing factor to elect out of Section 987(3). We recommend that this election not require the partners' use of equity and basis pool methods with respect to their partnership interests, and neither the partnership nor the partners would track unrecognized Section 987 gain or loss. The electing partnership, however, would still be required to apply sections 987(1) and (2) for purposes of computing the partnership's taxable income.

3. Clarification of elections to be made by partnerships under the 2024 Final Regulations

Of the various elections permitted by the 2024 Final Regulations, only two are specifically listed as elections permitted to be made by partnerships. The 2024 Final Regulations permit other taxpayers to make at least eight other types of elections. In certain cases, it appears that a partnership might take an approach that is consistent with one of these other types of elections as part of its "reasonable method." It would be helpful for the IRS and Treasury to clarify in this situation whether the partnership needs to make a formal election or report on IRS Form 8964-ELE any "quasi elections" that are part of its reasonable method.

III. General Background on Section 987

A. Statutory Treatment of Branch Foreign Currency Gains and Losses

As part of the Tax Reform Act of 1986,[8] Congress added to the Code subpart J, which adopted the concept of functional currency for purposes of determining foreign currency gains or losses for U.S. federal income tax purposes. Except when required to use the U.S. dollar as its functional currency, the functional currency of a qualified business unit ("QBU")[9] is generally the currency of the economic environment in which a significant part of the QBU's activities are conducted.[10] Subpart J provides three mechanisms for taking into account activities in non-functional currencies: Section 986 (translation of foreign taxes and the earnings and profits of foreign corporations, including, under Section 986(c) with respect to foreign currency gain or loss on distributions of previously taxed earnings and profits of CFCs and passive foreign investment companies); Section 987 (translational gain or loss from the activities of QBUs); and

[8] Pub. L. No. 99-514, 100 Stat. 2085.

[9] The term QBU means any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. Section 989(a). Corporations, individuals, trusts, and estates are "per se" QBUs. Treas. Reg. § 1.989(a)-1(b)(1). Treasury and the IRS continue to study the treatment of partnerships as QBUs, and the consequences for such determination for the application of Section 987. See Preamble to the 2024 Final Regulations, T.D. 10016, 89 Fed. Reg. 100151 (Dec. 11, 2024).

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

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Section 988 (transactional gain or loss from certain financial transactions denominated in a nonfunctional currency).

Section 987 governs the treatment of any taxpayer that owns a QBU with a functional currency other than the U.S. dollar. Section 987 is intended to be helpful to taxpayers operating business activities through a branch by permitting accounting for income and loss to be determined using the branch's functional currency in lieu of tracking every transaction separately as would generally be required under Section 988. As provided in Section 987(1) and (2), the taxable income or loss is computed separately for each QBU in its functional currency and such amount is then translated into the owner's functional currency at the appropriate exchange rate. Under Section 987(3) and regulations prescribed by the Secretary, "proper adjustments" are to be made for transfers of property between QBUs of the taxpayer that have different functional currencies. These adjustments include treating remittances as having been made out of accumulated earnings and treating resulting gain or loss as ordinary income or loss. The intention of these rules is that the owner of a QBU (a) accounts for earnings, basis in assets, and liabilities of a QBU in the QBU's currency, (b) translates the QBU's earnings, basis in its assets and liabilities at appropriate rates when translation is relevant, and (c) recognizes any translation-based foreign exchange gain or loss inherent in the capital and accumulated earnings of the QBU upon a distribution of cash or property, i.e., a remittance, from the QBU or a termination of the owner's interest in the QBU.

B. Regulatory Efforts

Treasury and the IRS have issued guidance under Section 987 multiple times. Proposed Regulations were issued in 1991 and 2006, and final Regulations were issued in 2016, along with temporary and proposed Regulations. Certain aspects of the 2016 temporary and proposed regulations were finalized in 2019. With limited exceptions, the effective date of those final Regulations was deferred multiple times.

In 2023, Treasury and the IRS made an additional effort to provide generally applicable rules, governing the computation of taxable income of owners of QBUs. These rules were finalized in large part in 2024. The 2024 Final Regulations retain the foreign exchange exposure pool ("FEEP") method from the 2016 final regulations as a default rule, with some changes and simplifying elections.[11] Under the FEEP method, the owner of a QBU determines all items of

[11] Consistency rules require Section 987 elections to apply to all members of a U.S. consolidated group, and certain CFCs and foreign partnerships if certain ownership requirements are met. In general, in the context of mergers and acquisitions ("M&A"), the acquirer's election status controls and the target must conform to such election status (see, e.g., Treas. Reg. § 1.987-1(g)(2)(i) ("If a corporation becomes a member of a consolidated group, it is deemed to make or revoke any Section 987 election as necessary to be consistent with the consolidated group."), Treas. Reg. § 1.987-1(g)(2)(ii) ("If an entity that was not previously a member of the Section 987 electing group becomes a member (for example, upon formation or acquisition), it is deemed to make or revoke any Section 987 election as necessary to be consistent with the other members."), and Treas. Reg. § 1.987-1(g)(2)(iii) ("If a corporation (acquiring corporation) acquires the assets of another corporation in a transaction described in Section 381(a), the acquiring corporation's election status applies to all Section 987 QBUs owned by the acquiring corporation after the transaction."). In addition, pursuant to Treas. Reg. § 1.987-1(g)(3)(ii), a Section 987 election may generally not be made or revoked without the Commissioner's consent. For this purpose, the

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income or loss in the QBU's functional currency and then translates those items into the owner's functional currency.[12]

In addition, each year the owner of a QBU is required to determine its net unrecognized Section 987 gain or loss based upon the annual increase or decrease to the QBU's balance sheet attributable to foreign exchange rate fluctuations. In general, this balance sheet is calculated as the aggregate amount of functional currency and the adjusted basis of each QBU asset on that day, minus the QBU's liabilities, in each case translated into the owner's functional currency.[13] The 2024 Final Regulations provide a 10-step procedure for making such determination, which includes, among other items, adjustments for transfers of assets between the QBU and its owner, adjustments to account for the impact of earnings and losses, and tracking of items of income and deduction not otherwise included in the determination of taxable income.[14] In making these computations, the owner translates "marked assets" using the average rate for the current year. Marked assets are generally defined as assets that would generate gain or loss under Section 988 if held directly by the owner of the QBU.[15] For other assets, labeled "historic assets," the owner of the QBU translates the basis of such assets at the exchange rate at the time such assets were acquired, i.e., the historic rate. The balance sheet approach, together with the use of historic rates for historic items, was believed to allow taxpayers and the IRS to distinguish between items whose value is highly responsive to changes in the functional currency of the owner and items for which exchange rate changes have no effect on value, or only an uncertain or remote effect that is more appropriately recognized upon a realization event with respect to the item.

An owner of a QBU is required to recognize unrecognized Section 987 gain or loss when there is a "remittance" from the QBU to the owner. The approach generally looks at the percentage of the Section 987 QBU's assets that have been transferred to the owners. There are also rules that suspend or defer a taxpayer's ability to claim losses that would be otherwise recognized. For example, there is a "loss-to-the-extent-of- gain" rule that is applicable to losses that would otherwise be recognized where the owner of the QBU has made a current rate election but has not also made an annual recognition election.

The 2024 Final Regulations offer little guidance on the treatment of partnerships. Treas. Reg. § 1.987-7(b) provides generally that the regulations do not apply to partnerships and do not

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Commissioner's consent may be obtained only with a ruling or administrative pronouncement. One such exception is provided by Treas. Reg. § 1.987-1(g)(3)(ii)(C), which allows an authorized person to make a Section 987 election without the consent of the Commissioner on its original, timely filed (including extensions) return for the first taxable year of an owner in which the Section 987 regulations apply and either the owner or any member of its consolidated group or Section 987 electing group is the owner of a Section 987 QBU.

[12] Treas. Reg. § 1.987-3, Treas. Reg. § 1.987-4, and Treas. Reg. § 1.987-5.

[13] Treas. Reg. § 1.987-4(e)(1). For this purpose, generally the basis of "marked assets" (generally assets that would be described in Section 988) are translated at current exchange rates, and "historic assets" are translated at historic exchange rates.

[14] Treas. Reg. § 1.987-4.

[15] Treas. Reg. § 1.987-1(d).

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apply to an eligible QBU if a partnership is the owner of the assets and liabilities under federal income tax rules. Instead, a taxpayer must apply sections 987 and 989(a) to partnerships and eligible QBUs owned by partnerships in a "reasonable manner" using a consistently applied method.[16] Certain rules apply to an eligible QBU if a partnership is the owner of the QBU's assets and either the partnership treats the QBU as a QBU of the partnership or a partner treats all or a portion of the eligible QBU as a QBU of the partner. In general, the applicable rules are those dealing with character of income, information reporting and deferral or suspension of loss. Additionally, whether the partnership or partner is treated as the owner of the eligible QBU, such owner must adapt the rules governing character and deferral in a manner that is consistent with the purposes of those provisions.

Concurrent with the publication of the 2024 Final Regulations, Treasury and the IRS issued a notice of proposed rulemaking which, in part, announced the intention to study whether there are instances in which the application of Section 987(3) to controlled foreign corporations ("**CFC**s") and partnerships with only foreign partners could be simplified.[17] The preamble noted a concern that, in the absence of the application of Section 987(3) to CFCs, economic currency gain could give rise to an increase in a CFC's aggregate inside basis (in U.S. dollar terms) without a corresponding increase in E&P for the CFC.[18] Treasury and the IRS noted their view that this difference, resulting in "excess asset basis" within the meaning of Treas. Reg. § 1.367(b)-3(g), could be imported into the United States and escape U.S. taxation permanently in the case of an inbound asset reorganization or liquidation.

In Notice 2026-17, Treasury and the IRS announced their intent to issue proposed regulations on certain aspects of computation and application of Section 987 to simplify the operation of the regulations, reduce compliance burdens, and refine the scope of certain rules to limit their effect on ordinary course of business transactions. Two sections are particularly relevant to this report.

Section 3 of the notice provides that forthcoming proposed regulations would allow taxpayers to make an election, for any taxable year for which a current rate election is in effect, to determine taxable income or loss and foreign currency gain or loss with respect to a QBU using a method that is substantially similar to the method provided in 1991 regulations (i.e., an equity and basis pool method). If an election to use this method is in effect, taxpayers would

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[16] Treas. Reg. § 1.987-7(b). All members of the same controlled group must apply the same method for a particular partnership or eligible QBU. Before the 2024 Final Regulations, the 2016 regulations required certain closely held partnerships to use an aggregate approach and provided for other partnerships to be treated as a QBU. Regulations proposed in 2023 would have maintained the look-through approach by certain closely held partnerships and would have otherwise applied a "hybrid approach" pursuant to which the partnership would be treated as the sole owner of a Section 987 QBU, with the partnership having its own functional currency. In contrast, the 2024 Final Regulations do not require any partnership to use an aggregate or a hybrid approach.

[17] Notice of Proposed Rulemaking, Accounting for Disregarded Transactions Between a Qualified Business Unit and its Owner, 89 Fed. Reg. 99782 (Dec. 11, 2024).

[18] 89 Fed. Reg. 99782 at 99786.

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determine Section 987 taxable income or loss, net unrecognized Section 987 gain or loss, and recognized Section 987 gain or loss for a QBU as follows:

(1) Section 987 taxable income or loss. In general, taxpayers would determine Section 987 taxable income or loss by computing each item of income, gain, deduction, or loss attributable to the QBU in its functional currency and then translating the net taxable income or loss into the owner's functional currency at the yearly average exchange rate.

(2) Net unrecognized Section 987 gain or loss. In general, net unrecognized Section 987 gain or loss would equal the equity pool on the last day of the tax year translated into the owner's functional currency at the spot rate on that day, minus the basis pool on the last day of the tax year. The equity pool is determined in the functional currency of the QBU and is increased (or decreased) by the amount of income and gain (or loss and deduction) attributable to the QBU for the taxable year, and is increased (or decreased) by the amount of each transfer from the owner to the QBU (or from the QBU to the owner). The basis pool is maintained in the functional currency of the owner and subject to the same adjustments as the equity pool.

(3) Recognized Section 987 gain or loss. Subject to the rules of Treas. Reg. §§ 1.987-11 through 1.987-13, the Section 987 gain or loss recognized for a tax year would equal the owner's net unrecognized Section 987 gain or loss multiplied by the remittance proportion, as defined in the notice.

The equity and basis pool election would not apply to Section 987 QBUs owned by or through a partnership or S corporation, or to a partnership that is itself treated as a QBU. The notice provides, however, that a method consistent with Section 3 of the notice (or a similar method, such as the method described in the 1991 proposed regulations) is treated as a reasonable method for purposes of Treas. Reg. §1.987-7(b). This statement supports the partnership-level approach we recommend in Part V of this Report. Section 5 of the notice states that Treasury and the IRS intend to issue future guidance establishing an election under which CFCs generally would not be required to compute or recognize foreign currency gain or loss under Section 987(3) ("**CFC Election**"). However, the rules of Section 987(1) and (2) would continue to apply for purposes of computing the taxable income and E&P of the CFC with respect to its Section 987 QBUs. The basis of assets and amount of liabilities transferred between a Section 987 QBU and its owner would generally be translated at the spot rate applicable on the date of the transfer. The notice provides that, in the case of an inbound transaction, rules would be provided to account for Section 987(3) gain (but not loss) that had not been recognized as a result of the CFC Election. It proposed that taxpayers would account for this gain by determining the CFC's inside basis in its assets increased (in U.S. dollar terms) due to currency fluctuations, which in principle would represent the net amount by which the basis in the CFC's assets increased due to currency fluctuations that would have been accounted for under Section 987(3) had the CFC Election not been made.

The 2026 Proposed Regulations propose rules pursuant to which Section 987(3) generally would not apply to a CFC that makes an exemption election (an "exempt CFC") for years in which the election is in effect, except in a year in which certain inbound transactions occur. The

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CFC Election would be subject to the general consistency rules of the 2024 Final Regulations described above.[19] An exempt CFC would not be subject to the rules of the 2024 Final Regulations relating to the determination and recognition of Section 987 gain or loss, and would be deemed to have a current rate election in effect so that it would not be required to track historic exchange rates. The amount of a QBU's taxable income or loss would be translated into the owner's functional currency at the yearly average exchange rate, and transfers between a QBU and its owner would be translated at the spot rate on the date of the transfer. Taxpayers may rely on the 2026 Proposed Regulations for taxable years beginning after December 31, 2024, if the rules are applied consistently by all members of the applicable Section 987 electing group. For taxable years beginning after December 31, 2024, and ending on or before December 31, 2026, the election generally is made on an original, timely filed return, although for taxable years beginning in 2025 it may also be made on an amended return filed by October 15, 2027; for taxable years ending after 2027, the election generally must be made on or before the first day of the taxable year to which it applies.

Furthermore, an exempt CFC would not compute or recognize Section 987 gain or loss with respect to an "exempt partnership QBU," including (1) a partnership treated as a QBU of an exempt CFC or (2) a QBU that is indirectly owned by an exempt CFC through a partnership. In addition, if a partnership is treated as the owner of a QBU, and at least 80 percent of the capital or profits interests in the partnership are owned by exempt CFCs that are members of the same controlled group (an "exempt partnership"), the QBU would be an exempt partnership QBU, and the exempt partnership would not compute or recognize gain or loss with respect to that QBU. In both cases, the CFC or partnership, as applicable, would be required to continue to apply sections 987(1) and (2) in a reasonable manner.

The 2026 Proposed Regulations contain transition rules for exempt CFCs and exempt partnerships to compute pre-election Section 987 gain or loss and amortize it over a period of 120 months. In the case of an exempt partnership, this amount would be amortized by the partners. A de minimis rule would be provided for a QBU with assets less than $50 million.

In the case of an inbound liquidation or reorganization of an exempt CFC, the 2026 Proposed Regulations would require the transferor CFC to compute and recognize gain equal to the amount of its "Section 987 asset basis," an amount meant to reflect the amount by which the aggregate basis of the assets acquired in the inbound nonrecognition transaction has been increased by appreciation in the value of a Section 987 QBU's functional currency.

IV. Recommendations related to the 2026 Proposed Regulations

We commend Treasury and the IRS for proposing the CFC Election, because it will reduce complexity and improve administrability for certain taxpayers and includes appropriate safeguards to prevent the creation of undue opportunities for abuse. The proposed election substantially reduces the annual compliance burden for taxpayers operating their non-U.S.

[19] Prop. Treas. Reg.§ 1.987-15(c)(1) ("The consistency rules of § 1.987–1(g)(2) apply with respect to a CFC Election, subject to the modifications described in paragraph (c)(2) of this section and the anti-avoidance rule provided in paragraph (c)(3) of this section.").

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activities through QBUs owned by one or more CFCs, particularly in circumstances in which the assets of the QBUs are not expected to be repatriated to the United States. We reiterate, however, several suggestions from our earlier comments and have several additional suggestions for final guidance.

A. Inbound Transactions

As discussed above, in an inbound asset reorganization, taxpayers may inbound assets the basis of which reflect currency appreciation without the current or future recognition of the unrecognized appreciation. Notice 2026-17 proposed three methods to address this issue, including (1) calculating and recognizing the Section 987(3) gain immediately before the inbound transaction, (2) reducing the basis of the assets acquired in the hands of the domestic acquiring corporation, or (3) if the QBU remains a QBU in the hands of the domestic acquiring corporation, adjusting the amount of the unrecognized Section 987 gain or loss in its hands by the basis adjustment (such that the gain would be deferred and recognized by the acquiring corporation under the 2024 Final Regulations). The 2026 Proposed Regulations took the first approach.

We understand Treasury's and the IRS's concern about the importation of property with higher basis that reflects what would have been Section 987 gain if the exempt CFC had not made the CFC Election. We also appreciate the addition of a de minimis rule for the computation of such adjustments and the provision of administrative expedients for calculating such amounts.

We believe, however, that recognizing such gain (but not loss) in the case of an exempt CFC is not necessary to prevent such abuse, and we reiterate the suggestion in our previous comments that upon an inbound asset reorganization a shareholder should reduce basis in the imported assets, rather than recognizing gain, for the Section 987 gain (but not loss) that would have been taken into account by the CFC had it not made the CFC Election. The basis adjustment addresses Treasury and the IRS's primary concern that economic gain could escape taxation due to the inbound transaction.

Accordingly, we recommend treating the calculated amount as a reduction of the CFC's inside basis in its assets immediately before the transaction (i.e., option 2 in Notice 2026-17). Reducing the basis of the assets received in the hands of the domestic acquiring corporation to account for the unrecognized Section 987 gain is the most consistent with the purposes of both the CFC Election and the special inbound transaction rules. The Section 987 basis adjustment rule is intended to ensure that the transferee effectively does not obtain a basis increase attributable to the unrecognized Section 987 gain by requiring an offsetting downward basis adjustment. Reducing the basis of the assets of the domestic acquiring corporation to account for the unrecognized Section 987 gain rather than requiring current recognition of gain would be most consistent with the treatment of any unrecognized gain not attributable to foreign currency movement in an inbound asset reorganization or liquidation described in Treas. Reg. § 1.367(b)-3(a) (i.e., such gain is deferred and ultimately recognized by the transferee).

Under this approach, because the Section 987 adjustment is an aggregate amount, an allocation method is needed to adjust the basis of the assets received in the inbound reorganization. A pro-rata adjustment basis of the assets based on the basis of each asset received

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(determined in U.S. dollars by the domestic transferee) or based on relative fair market value are each consistent with general tax principles, Treas. Reg. § 1.367(b)-3 and Section 1060.

We acknowledge that the effect of the CFC Section 987 basis reduction could be viewed as converting what otherwise represents Section 987 foreign currency gain into unrecognized gain of a different character and source. We note, however, that this is the same effect when a corporation that uses a functional currency other than the U.S. dollar liquidates or reorganizes inbound into a U.S. corporation – amounts that economically relate to currency fluctuations are converted into asset basis under the mechanics of Treas. Reg. §§ 1.367(b)-2(j) and 1.985-5 because the assets are not held in a Section 987 branch.[20]

Nevertheless, based on this concern, Treasury and the IRS may conclude that additional rules are needed to prevent abuse and/or unintended consequences from the conversion of the character and source of the gain or loss if a basis adjustment were permitted. We considered a variety of approaches to prevent character and source conversions, each of which is based on preserving aspects of the character and source of the Section 987 gain that would have been recognized at the time of the inbound transaction.

One mechanism to prevent this conversion would be to recharacterize an amount of gain on a subsequent sale of an inbounded asset as Section 987 gain to the extent of the CFC Section 987 basis adjustment (determined based on the allocation of the adjustment to the basis of each asset, as discussed above). This amount could retain the character and source that the amounts would have had under Treas. Reg. § 1.987-6 as of the date of the inbound transaction. This mechanism preserves the source and character of the unrecognized gain in the hands of the domestic transferee.

For example, assume that in an inbound liquidation of a foreign subsidiary, the domestic transferee is required to make a $20 basis adjustment to an asset to reflect $20 of unrecognized Section 987 gain at the time of the inbound transaction. Assume that, immediately after the inbound transaction, the assets formerly held by the CFC's QBU are now held directly by the domestic transferee. Assume further that the domestic transferee sells the asset one year after the inbound transaction and recognizes $30 of gain. The proposed rule would characterize $20 of the gain as ordinary income with the source determined under the rules of Treas. Reg. § 1.987-6 as of the date of the inbound transaction. If the $20 of gain is characterized as, say, entirely Section 951A income, such character and source should apply upon the ultimate recognition of the gain by the domestic transferee. If the asset were sold at a $10 gain, we propose that all $10 of gain is characterized as ordinary income and sourced under Treas. Reg. § 1.987-6. Finally, if the asset were sold at a loss as compared to its adjusted basis, the abuse about which Treasury and the IRS are concerned is not present because the taxpayer is not converting foreign currency gain into a capital gain. Instead, the taxpayer has an economic loss on the asset that exceeds the amount that would have been recognized as Section 987 gain.[21]

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[20] See also Section 986(c).

[21] We note that more detailed rules may be required in the case of assets eligible for depreciation or depletion deductions.

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We note that this approach only recharacterizes the net gain recognized on the asset, rather than recognizing the gross gain that would have been recognized at the time of the inbound transaction and creating an offsetting loss. The "split" gross character approach, which we recommended below for partnerships, aligns with the fact that partnership sales or liquidating distributions may result in an ordinary income inclusion and capital loss being recognized. Splitting the character of gain into gross income and a newly created capital loss does not align with the general principles applicable to single asset sales. The "net" character approach, which is similar to Section 1245 recapture, preserves the Section 987 attributes on an amount of gain actually recognized by the domestic transferee.

The character and source preservation approach outlined above ought to be able to work in circumstances in which the CFC's QBU assets are held in a QBU of the domestic transferee after the inbound transaction. The character and source of the historic gain could be preserved, as if the excess basis amount were treated as unrealized Section 987 gain, by using mechanics similar to the successor deferral QBU rules (i.e., that remittances out of the domestic transferee's QBU could trigger a pro-rata recognition of excess basis amount as Section 987 gain or loss).[22]

We note that such a rule requires tracking the Section 987 basis adjustment for future recharacterization of any gain on disposition. This tracking may be more administratively burdensome than merely triggering the gain at the time of the inbound liquidation. In this case, it may be appropriate to make the basis adjustment and character tracking elective so that taxpayers may "elect in" the more burdensome, but arguably more accurate, treatment.

B. M&A Transactions

As indicated above, in the context of M&A transactions, the acquirer's Section 987 election status controls and the target must conform to such election status. This includes the CFC Election. There are a number of fact patterns where this rule could apply, including the sale of a CFC to an unrelated U.S. shareholder (so CFC status is preserved).

1. Potential modifications and exceptions to the acquirer's-election-controls rule

The primary issue is under what circumstances would it be appropriate to have exceptions (e.g., when the acquirer and target have a different election status) to the acquirer's-elections-control rule and how should such exceptions operate. As described below, we recommend maintaining the general rule that the acquirer's Section 987 election status controls and the target QBUs must conform to such status, subject to three possible refinements discussed below: (i) providing a transition rule governing the timing of any required change in the target QBUs' election status, (ii) clarifying which group is treated as the acquirer following a transaction qualifying as a reverse acquisition under the consolidated return Regulations, and (iii) potentially adding an exception where the target QBUs exceed the acquirer's QBUs based on gross assets. While these refinements are proposed in the context of the CFC Election, these comments could be relevant to all Section 987 elections.

[22] See, e.g., Treas. Reg. § 1.987-12.

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First, on August 25, 2026, Treasury and the IRS issued proposed Regulations (REG-115646-25) that would implement revisions to the pro rata share rules, which were enacted under the One Big Beautiful Bill Act. In general, the proposed Regulations would allocate a CFC's subpart F income and tested income (or tested loss) to shareholders under a daily proration approach. Absent a closing of the CFC's taxable year, daily proration would allocate the CFC's full-year net amounts by ownership days, without regard to when particular items arose. The proposed regulations would require a closing of the CFC's taxable year only when a foreign corporation becomes or ceases to be a CFC and would permit an elective closing only for ownership shifts of more than 50 percent involving unrelated parties. The interaction of this daily proration rule with the Section 987 rule above would have seemingly unintended consequences if, say, a target CFC that had been applying the CFC Election were acquired by a group that had not made the CFC Election. If the target CFC had to immediately apply Section 987 to its QBUs, the selling shareholder could be allocated its pro rata portion (based on its days of ownership) of the Section 987 gain or loss from such QBUs even though it had been applying the CFC Election. The preamble to the 2026 Proposed Regulations acknowledges this issue, requesting comments on whether special rules should be provided for cases in which an acquired CFC's taxable year does not end at the time of the acquisition and on coordinating the consistency rules with the statutory changes to the pro rata share rules.

Therefore, in the event the acquisition would cause a change in election status of the target QBUs, the target QBUs should maintain their election status for the remainder of the target CFC's taxable year in which the acquisition occurs (including any short taxable year resulting from a closing of the CFC's taxable year or from a change in taxable year required by Section 898) in light of the new daily proration approach. Starting at the beginning of the next tax year, the target CFCs should conform their election status to that of the acquirer. Following the repeal of the one-month deferral election under former Section 898(c)(2) for taxable years of specified foreign corporations beginning after November 30, 2025, a target CFC generally must use the taxable year of its majority U.S. shareholder, and an acquisition of more than 50 percent of the target may require the target to conform its taxable year to the acquirer's; this recommendation therefore generally would align the target's conformity date with the beginning of its first full taxable year in the acquirer's hands.[23]

Second, it would be helpful for final Regulations to clarify that, where the reverse acquisition rule in Treas. Reg. § 1.1502-75(d)(3) applies, the consolidated group that is treated as continuing should be treated as the acquirer for purposes of determining the controlling Section 987 election status. As described above, under Treas. Reg. § 1.987-1(g)(2)(i), if a corporation becomes a member of a consolidated group, it is deemed to make or revoke any Section 987 election as necessary to be consistent with the consolidated group. Accordingly, it would appear that, where a target group continues, and an acquiring group terminates, under Treas. Reg. § 1.1502-75(d)(3), the members of the acquiring group must conform their Section 987 elections,

[23] Consistent with the general rule applicable to making a CFC Election, any unrecognized Section 987 gain of the target CFC as of the end of its taxable year in which the acquisition occurs would be required to be amortized over a 120-month period beginning with the first month of the taxable year in which the CFC Election becomes effective.

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including an election to exempt its CFCs under Section 987(3), to those of the continuing target group. The reverse acquisition rule should apply where it potentially conflicts with the rule for acquisitions to which Section 381 applies under Treas. Reg. § 1.987-1(g)(2)(iii). It would be helpful for this result to be confirmed in connection with the issuance of final Regulations.

Third, an additional modification to the acquirer's-elections-control rule exception seems warranted where the Section 987 QBUs of the acquirer CFC group represent a relatively small portion of the combined gross assets of the Section 987 QBUs of the acquiring and target CFC groups following the acquisition, and they have a different election status from the election status of the Section 987 QBUs of the target group's CFCs. For example, assume that the Section 987 QBUs of the acquiring CFC group have aggregate gross assets of $10 million and the Section 987 QBUs of the target CFC group have aggregate gross assets of $100 million. Further assume that the CFC Election was not made with respect to the acquiring CFC group but was made with respect to the target CFC group. To require the Section 987 QBUs of the target CFCs to now compute Section 987 for those QBUs does not seem equitable.

Specifically, consideration could be given to providing, through a revenue procedure or other published guidance, an exception to the general rule where the relative size of the target group warrants allowing the target group's Section 987 election status to govern. Under the 2024 final regulations, a Section 987 election generally may not be made or revoked without the consent of the Commissioner, with such consent obtained pursuant to the procedures prescribed in Rev. Proc. 2024-1 (or its successor), absent an otherwise applicable exception. Rather than requiring taxpayers to obtain individualized consent in the circumstances described below, the proposed Revenue Procedure could provide an expedited, automatic consent procedure for making or revoking a Section 987 election when specified objective conditions are satisfied.

For example, such guidance might provide that the exception applies where, immediately before the acquisition, the Section 987 QBUs of the target group represent, say, 50 percent or more of the aggregate amount of gross assets (using GAAP amounts) of all Section 987 QBUs that will be owned by the combined group immediately after the acquisition. A taxpayer satisfying the conditions of the revenue procedure would be permitted to make or revoke the CFC Election automatically, without separately requesting the Commissioner's consent under the otherwise applicable procedures, thereby allowing the target group's Section 987 election status to govern.

For transactions involving controlled foreign corporations outside the consolidated return context, the exception could apply based on a comparison of the aggregate QBU gross assets (using GAAP amounts) of each combining group, as the conditions of Treas. Reg. § 1.1502-75(d)(3) cannot be directly satisfied in those situations.

2. Effect of certain changes in ownership of an exempt CFC

A related question is how the transfer of a CFC (e.g., through a sale of stock of the CFC so that it is no longer owned by the same U.S. shareholder or a member of an exempt CFC group) should affect the unamortized amount of the pre-election or pre-transition Section 987 gain or loss (should there be, for example, acceleration or carryover of the amortization)?

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In general, these unamortized amounts are tax attributes of the CFC owner of the QBU and therefore unamortized amounts would become tax attributes of the acquirer group upon acquisition of the target CFC.[24] Given that, the unamortized amounts could be viewed like any other tax attribute of a corporation that continues when its shares are acquired.

There is, however, a special rule in the 2026 Proposed Regulations for pre-election unamortized amounts if an exempt CFC is sold to an unrelated party and the exempt CFC has unrecognized *pre-election* Section 987 gain or loss with respect to a QBU that had previously been transferred by the exempt CFC to a member of its controlled group.[25] Under this rule, the exempt CFC does not recognize any pre-election Section 987 loss with respect to the QBU in the taxable year of the transaction and subsequent taxable years. However, the exempt CFC continues to recognize pre-election Section 987 gain with respect to the QBU. Any pre-election Section 987 loss that is not recognized is treated as suspended Section 987 loss of the exempt CFC described in § 1.987–13(e).[26] The preamble states:

> This rule is intended to prevent taxpayers from engaging in loss trafficking by selling an exempt CFC with a pre-election Section 987 loss attribute to an unrelated person that does not also acquire ownership of the QBU to which the loss is attributable. When this rule applies, the CFC would recognize the suspended Section 987 loss only to the extent of Section 987 gain recognized in a taxable year in which it is no longer subject to the CFC Election.

An alternative approach would be for pre-transition and pre-election amounts of CFCs, which have already been computed and have known amortization schedules, to remain with the exempt transferor group and continue to be amortized for the balance of the 120-month period. Conceptually, since these amounts affect[27] U.S. shareholder inclusions through subpart F and Net CFC Tested Income (NCTI), they are also U.S. shareholder attributes that arguably should remain with the U.S. shareholder. Such a rule would provide symmetrical treatment of gains and losses, and an acquiring group would not inherit these pre-acquisition gains and losses (so there would be no loss trafficking concern), which have already been computed. Finally, the characterization of these amounts as subpart F and NCTI pursuant to the characterization rules of Treas. Reg. § 1.987-6 would have been already determined upon the establishment of the amounts. Therefore, the characterization of the future amortization of these amounts may be relatively straightforward. We recognize, however, that retaining these amounts with the historic U.S. shareholder could raise significant administrative and technical issues, including the treatment of associated foreign tax credits and the computation of the Section 250 deduction after the historic U.S. shareholder no longer owns the CFC. These and other considerations may make

[24] With respect to pre-transition gain/loss being amortized see Treas. Reg. § 1.987-10(e)(5)(ii). With respect to pre-election gain/loss being amortized see Prop. Treas. Reg. § 1.987-15(e)(3)(i).

[25] Proposed Treas. Reg. § 1.987-15(e)(3)(iv)(A).

[26] Proposed Treas. Reg. § 1.987-15(e)(3)(iv)(B).

[27] These amounts would also affect a CFC's earnings and profits as the amounts are amortized.

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such an approach impractical or require additional rules that could outweigh its potential benefits.

C. Exempt Partnerships

1. Basis adjustments and acceleration of Section 987 gain or loss upon sale of partnership interest

As discussed above, the 2026 Proposed Regulations would require exempt CFCs to compute and amortize pre-election Section 987 gain or loss and amortize it over a 120-month period. An exempt partnership would be required to compute this gain or loss in the same manner as an exempt CFC. The partnership would not include the gain or loss itself, but rather each partner (or indirect partner in the case of a partner that is a partnership) would take into account its share ratably over a 120-month period.[28] The partner's share would be determined based on the amount of Section 987 gain or loss with respect to the QBU that would be included in the partner's distributive share of profits or losses if the partnership recognized the entire amount of pre-election gain or loss in the first taxable year for which the exemption election applies.[29]

The partner's basis in the exempt partnership would be increased or decreased for this pre-election gain or loss amount, consistent with the general approach to adjusting partnership interest basis under the 2024 Final Regulations. Treasury and the IRS requested comments on whether the exempt CFC should adjust the basis in its partnership interest by the full amount of the pre-election gain or loss in the first taxable year in which the exemption election applies, whether the recognition of the pre-election gain or loss should be accelerated if an exempt CFC sells its partnership interest during the 120-month amortization period, and whether rules are needed for cases in which an exempt CFC transfers its partnership interest in a Section 351 or Section 721 transaction during the amortization period.

With regard to the adjustment to basis of the partnership interest and inclusion of pre-existing gain or loss, generally we recommend that the rules operate to prevent duplication of the pre-existing gain or loss. Thus, regardless of whether basis is adjusted immediately or over the amortization period, adjustments to basis or acceleration of pre-existing gain or loss should be required in certain circumstances in which the partner disposes of some or all of the interest in the exempt partnership or receives a distribution from the partnership.

To effectuate this, we would recommend one of two possibilities: (1) the CFC's basis in the partnership interest is adjusted over the amortization period as pre-election gain or loss is included, with the basis adjustments (and a corresponding amount of pre-election gain or loss) accelerated if the CFC would otherwise recognize gain or loss on sale of a partnership interest (or as a result of a distribution) that would be a duplication of the pre-election gain or loss or (2) the CFC's basis in the partnership interest is adjusted immediately for the total amount of the

[28] Prop. Treas. Reg. § 1.987-15(g)(3)(ii)(A). An allocation to the direct and indirect partners will tend to prevent pre-election Section 987 gain or loss from shifting to a new partner (or shifting among partners) upon the sale or transfer of a partnership interest.

[29] Prop. Treas. Reg. § 1.987-15(g)(3)(ii)(B).

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unrecognized Section 987 gain or loss, with an acceleration of the pre-election gain to the extent that increased basis would be recovered and an acceleration of the pre-election loss to the extent a portion of the interest is disposed of, in each case before the end of the amortization period. In either case, adjustments would need to be made through tiers of partnerships (if any). The idea in either case would be to reach the same results, and we think the second approach (adjusting basis at the time of the exemption election) is likely to be simpler as shown by the examples below.

First alternative. Under the first alternative, the CFC's basis in the partnership interest (including through tiers of partnerships) would be increased or decreased as the CFC includes the pre-election gain or loss amount. If the CFC directly or indirectly transfers its partnership interest and would recognize gain or loss that would be duplicative of the pre-election gain or loss to be included over the amortization period, the CFC would instead accelerate a sufficient amount of the pre-election gain or loss and basis (including through tiers of partnerships) would be adjusted accordingly to eliminate, to the extent possible, the duplicative gain or loss resulting from the transaction. Similar rules would apply if the CFC receives a distribution from the partnership that would result in gain or loss. Special rules would be needed for transfers of the partnership interest in a Section 721 or Section 351 transaction. This alternative can be demonstrated with an example:

Example 1A: Pre-Election Unrecognized Section 987 Gain (Partnership Basis Adjusted Over Time)

CFC owns 99% of an upper tier partnership ("UTP"), which owns 99% of a lower tier partnership ("LTP"). The CFC and UTP both have a pound functional currency, and LTP has a euro functional currency. LTP bought €100 when the pound:euro exchange rate was 1:1. CFC's basis in UTP, and UTP's basis in LTP is £100. At the time CFC makes a CFC Election, the pound:euro exchange rate is 1:0.8. LTP's unrecognized Section 987 gain is £25. Based on the way that the partners share profits and losses in the year of the exemption election, the £25 gain will be included by CFC over the 120-month amortization period.

CFC increases its basis in UTP, and UTP increases its basis in LTP only as CFC includes the pre-election gain in income. At the end of year one, CFC has included £2.50 of the pre-election gain, CFC's basis in UTP and UTP's basis in LTP have each been increased by £2.50 to £102.50, and the exchange rates have not changed. In the alternative:

i. UTP sells part of its LTP interest

UTP sells 20% of its interest in LTP for £25 and would recognize £4.50 of gain (amount realized of £25 minus £20.50 recovery of basis). This gain would be duplicative of the pre-election gain that will eventually be included by CFC. Thus, we recommend that CFC be required to accelerate £4.50 of pre-election gain, for the basis in UTP and LTP to be increased by that amount immediately before the sale, and for UTP to recover £5 of basis on its sale of the interest. In other words, CFC would accelerate £4.50 of ordinary pre-election gain and UTP would recognize no gain or loss on the sale of the LTP interest. The result would be the same if instead CFC had sold part of its interest in UTP.

ii. LTP makes a distribution to UTP

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LTP sells €100 for £125 and distributes £125 to UTP. UTP would recognize gain on the distribution of £125. Again, this gain would be duplicative of the pre-election gain that will eventually be included by CFC. Thus, we recommend that CFC be required to accelerate the remaining pre-election gain and for the basis in UTP and LTP to be increased by that amount immediately before the distribution. Thus, UTP's basis in LTP would increase to £125, and UTP would not recognize gain or loss on the distribution.

iii. LTP makes a distribution to UTP and then UTP sells half of its LTP interest

LTP sells €20 for £25 and distributes £25 to UTP. UTP would not otherwise recognize gain or loss as a result of this distribution, so there is no acceleration of the pre-election gain. UTP then sells half of its remaining LTP interest for £50 and would recognize gain of £11.25.[30] This gain is duplicative of the pre-election gain that will eventually be included by CFC. Thus, we recommend that CFC be required to accelerate £11.25 of pre-election gain, for the basis in UTP and LTP to be increased by that amount immediately before the sale, and for UTP to recover £50 of basis on the sale of the interest.

iv. UTP contributes the interest in LTP to a middle tier partnership ("MTP").

Although not entirely clear, it appears that a contribution of the LTP (or UTP) interest at a time in which the basis has not been fully adjusted for the pre-election gain could give rise to a Section 743(b) adjustment (assuming LTP has a Section 754 election in effect) related solely to this pre-election gain or loss, and we recommend that adjustments be made to prevent this. A Section 743(b) adjustment is generally calculated as a partner's basis in the partnership interest (here, MTP's basis in LTP would be £102.50) minus the partner's share of basis of the partnership assets. The latter is calculated as the amount the partner would receive on liquidation (here, €100 which is now worth £125) minus the gain (or plus the loss) that would be allocated to the partner upon the sale of the LTP's assets.[31] Here, LTP would not recognize any gain or loss on the sale of its euros. Therefore, it appears that MTP would have a Section 743(b) adjustment of (£22.50) with respect to LTP.[32] In this first alternative, we would recommend that regulations provide that for purposes of calculating any Section 743(b) adjustment, the transferee partner's basis in the partnership takes into account any adjustments to basis that would otherwise be made as the CFC includes the pre-election gain amount in income, to prevent a Section 743(b) adjustment from arising solely as a result of this yet-to-be-recognized pre-

[30] Before these transactions, UTP's basis in LTP is £102.50. It is reduced by the £25 distribution to £77.50. On sale of half of the interest, we assume UTP would recover half of the basis, or £38.75. See Treas. Reg. § 1.61-6(a); Rev. Rul. 84-53, 1984-1 C.B. 159.

[31] See Treas. Reg. § 1.743-1(b)-(d).

[32] In general, we do not believe that a Section 743(b) adjustment can be made to a partnership's own functional currency (which is "money" rather than "property" from the partnership's perspective), and the LTP in this example does not have other assets, but the adjustment would be relevant if it did have other assets.

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election Section 987 amount. We believe the same considerations would apply if UTP contributes the LTP interest to a corporation in a Section 351 transaction.

Example 1B: Pre-Election Unrecognized Section 987 Loss (Partnership Basis Adjusted Over Time)

The facts are the same as above, except that at the time CFC makes a CFC Election, the pound:euro exchange rate is 1:2, and LTP's unrecognized Section 987 loss is £50. Based on the way that the partners share profits and losses in the year of the exemption election, the £50 loss will be included by CFC over the 120-month amortization period.

CFC decreases its basis in UTP, and UTP decreases its basis in LTP only as CFC includes the pre-election loss in income. At the end of year one, CFC has included £5 of the pre-election loss, CFC's basis in UTP and UTP's basis in LTP have each been decreased by £5 to £95, and the exchange rates have not changed. In the alternative:

i. UTP sells part of its LTP interest

UTP sells 20% of its interest in LTP for £10 and would recognize £9 of loss (amount realized of £10 minus £19 recovery of basis). This loss would be duplicative of the pre-election loss that will eventually be included by CFC. Thus, we recommend that CFC be required to accelerate £9 of pre-election loss, for the basis in UTP and LTP to be decreased by that amount immediately before the sale, and for UTP to recover £10 of basis on its sale of the interest.[33] The result would be the same if instead CFC had sold part of its interest in UTP.

ii. LTP makes a distribution to UTP

UTP sells €100 for £50 and distributes £50 to UTP in liquidation of its interest. CFC would recognize a loss of £45 which would be duplicative of CFC's eventual loss. Thus, we recommend that CFC be required to accelerate the remaining £45 of pre-election loss, and for the basis in UTP and LTP to be decreased by that amount immediately before the distribution, so that UTP does not recognize loss on the distribution.

iii. LTP makes a distribution to UTP and then UTP sells half of its LTP interest

UTP sells €20 for £10 and distributes £10 to UTP. UTP then sells half of its remaining LTP interest for £20 and would recognize loss of £22.50.[34] Because this loss would be duplicative of the pre-election loss that will eventually be included by CFC, we recommend that CFC be required to accelerate £22.50 of pre-election loss, for the basis in

[33] Treasury and the IRS also should consider whether to defer accelerated loss recognition in the case of a related party sale and, if so, how the deferral rule interacts with rules, such as Section 267(a) and (f), disallowing or deferring the partner's loss (if any) recognized on the sale of the partnership interest.

[34] Before these transactions, UTP's basis in LTP is £95. It is reduced by the £10 distribution to £85. On sale of half of the interest, we assume UTP would recover half of the basis, or £42.50. See Treas. Reg. § 1.61-6(a); Rev. Rul. 84-53, 1984-1 C.B. 159.

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UTP and LTP to be decreased by that amount immediately before the sale, and for UTP to recover basis of £20 in the sale.

iv. UTP contributes the interest in LTP to MTP.

As discussed in Example 1 above, if basis in the partnership interest is not fully adjusted in the year of the exemption election for the pre-election loss, we recommend that the regulations provide a special rule to prevent the creation of a Section 743(b) adjustment related solely to this gain or loss. Without such a special rule, the contribution of the LTP interest in this example could result in a Section 743(b) adjustment of £45 (MTP's basis in LTP of £95 minus the amount MTP would receive on liquidation, which is €100 and now worth £50).[35] We believe the same considerations would apply if UTP contributes the LTP interest to a corporation in a Section 351 transaction.

Second alternative. Under the second alternative, the CFC's basis in the partnership interest (including through tiers of partnerships) would be increased or decreased in the year of the CFC Election. If, during the amortization period, the CFC directly or indirectly disposes of part or all of its interest in the partnership or receives a distribution from the partnership, and recognizes more or less gain or loss than it would have but for the immediate basis adjustment, some or all of the remaining pre-election gain or loss would be accelerated. Special rules would be needed for transfers of the partnership interest in a Section 721 or Section 351 transaction. This alternative can be demonstrated with an example:

Example 2A: Pre-Election Unrecognized Section 987 Gain (Partnership Basis Adjusted Immediately)

CFC owns 99% of UTP, which owns 99% of LTP. The CFC and UTP both have a pound functional currency, and LTP has a euro functional currency. LTP bought €100 when the pound:euro exchange rate was 1:1. CFC's basis in UTP, and UTP's basis in LTP, is £100. At the time CFC makes a CFC Election, the pound:euro exchange rate is 1:0.8, and LTP's unrecognized Section 987 gain is £25. Based on the way that the partners share profits and losses in the year of the exemption election, the £25 gain will be included by CFC over the 120-month amortization period.

CFC increases its basis in UTP, and UTP increases its basis in LTP in the year of election. At the end of year one, CFC has included £2.50 of the pre-election gain, and CFC's basis in UTP and UTP's basis in LTP have each been increased to £125, and the exchange rates have not changed. In the alternative:

i. UTP sells part of its LTP interest

UTP sells 20% of its interest in LTP for £25 and does not recognize gain (because basis equals fair market value). Because UTP is recovering basis (and reducing gain) attributable to pre-election gain, CFC would be required to accelerate a portion of its pre-

[35] See Treas. Reg. § 1.743-1(b)-(d). In general, we do not believe that a Section 743(b) adjustment can be made to a partnership's own functional currency (which is "money" rather than "property" from the partnership's perspective), and the LTP in this example does not have other assets, but the adjustment would be relevant if it did have other assets.

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election gain equal to 20% of the excess of the original pre-election gain over the amount already included in income, or £4.50. The result would be the same if instead CFC had sold part of its interest in UTP.

ii. LTP makes a distribution to UTP

LTP sells €100 for £125 and distributes £125 to UTP. UTP does not recognize gain. CFC would be required to accelerate the remaining pre-election gain, because the associated basis was recovered. It is less clear how the rules should operate if LTP exchanges and distributes less than all of its remaining currency. For example, if it sells €90 for £112.50 and distributes that amount, UTP does not recognize gain. The most administrable rule might be to accelerate gain only to the extent a distribution of pounds would have resulted in Section 731(a) gain but for the immediate basis increase. Here, UTP would have recognized £10 of gain but for the basis increase, so the regulations might provide for UTP to accelerate £10 of unrecognized gain.

iii. LTP makes a distribution to UTP and then UTP sells half of its LTP interest

LTP sells €20 for £25 and distributes £25 to UTP. As a result, UTP's basis in LTP is £100 and is worth £100. If UTP then sells half of its remaining LTP interest for £50, it does not recognize gain. CFC would be required to accelerate a portion of its pre-election gain equal to 50% of the excess of the original pre-election gain over the amount already included, or £11.25.[36]

iv. UTP contributes the interest in LTP to MTP

Unlike in example 1, this contribution should not result in a Section 743(b) adjustment solely as a result of the pre-election gain amount, and thus we do not think the same special rules are necessary in this alternative. After the contribution, we recommend that the interest in MTP be treated like the interests in UTP and LTP with respect to events that might accelerate the CFC's pre-election gain.

Example 2B: Pre-Election Unrecognized Section 987 Loss (Partnership Basis Adjusted Immediately)

The facts are the same as above, except that at the time CFC makes a CFC Election, the pound:euro exchange rate is 1:2. LTP's unrecognized Section 987 loss is £50. Based on the way that the partners share profits and losses in the year of the exemption election, the £50 loss will be included by CFC over the 120-month amortization period.

CFC decreases its basis in UTP, and UTP decreases its basis in LTP, in the year of election. At the end of year one, CFC has included £5 of the pre-election loss, and CFC's basis in UTP and UTP's basis in LTP have each been decreased to £50, and the exchange rates have not changed. In the alternative:

[36] If UTP's basis had only been increased by £2.50 for the first year of pre-election Section 987 gain inclusion, it would have been £102.50 before these transactions, then decreased to £77.50 by the distribution. Upon sale of half of the remaining interest for £50, UTP would have recovered basis of £38.75 and would have recognized gain of £11.25.

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i. UTP sells part of its LTP interest

UTP sells 20% of its interest in LTP for £10 and does not recognize loss (because basis equals fair market value). Because UTP is recognizing less loss than it would have without an immediate basis decrease, we recommend that CFC be required to accelerate a portion of its pre-election loss equal to 20% of the excess of the original pre-election loss over the amount already included, or £9.[37] The result would be the same if instead CFC had sold part of its interest in UTP.

ii. LTP makes a distribution to UTP

LTP sells €100 for £50 and distributes £50 to UTP in liquidation of its interest. CFC would be required to accelerate the remaining pre-election loss, because but for the immediate basis decrease, CFC would have recognized a loss on the distribution.

iii. LTP makes a distribution to UTP and then UTP sells half of its LTP interest

LTP sells €20 for £10 and distributes £10 to UTP. If UTP then sells half of its remaining LTP interest for £20, it does not recognize loss. CFC would be required to accelerate a portion of its pre-election loss equal to 50% of the excess of the original pre-election loss over the amount already included, or £22.50.[38]

iv. UTP contributes the interest in LTP to MTP

Unlike in example 1, this contribution should not result in a Section 743(b) adjustment solely as a result of the pre-election loss amount, and thus we do not think the same special rules are necessary in this alternative. After the contribution, we recommend that the interest in MTP be treated like the interests in UTP and LTP with respect to events that might accelerate the CFC's pre-election loss.

Summary. Both frameworks discussed above attempt to prevent the duplication of the pre-election gain or loss and reach the same results in terms of timing of income or loss recognition. We think the second approach is likely to be simpler. If one of these approaches is adopted, we think additional rules will likely be necessary to determine the amount of the partnership interest transferred in more complicated situations (for example, if the partnership has more than one QBU or if the value of the assets changes). We also recommend that Treasury consider whether to accelerate pre-election Section 987 gain or loss (and adjust basis accordingly, if applicable) in other transaction in which the CFC's interest in the partnership is reduced, including a debt-financed distribution, or a contribution of money or property by another partner for an interest.

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[37] Treasury and the IRS also should consider whether to defer such accelerated loss recognition in the case of related party sales.

[38] If UTP's basis had only been reduced by £5 for the first year of pre-election loss inclusion, it would have been £95 before these transactions, then decreased to £85 by the distribution. Upon sale of half of the remaining interest for £20, UTP would have recovered basis of £42.50 and would have recognized loss of £22.50.

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2. Interaction with basis adjustments under Sections 734(b) and 743(b)

In addition to the basis adjustment issues discussed above, we recommend that Treasury and the IRS also consider the mechanics of adjustments under Sections 734(b) and 743(b) for an exempt partnership owned by an exempt CFC with a different functional currency. Without special rules, currency fluctuations may give rise to potentially inappropriate Section 734(b) or Section 743(b) adjustments. Over time, currency fluctuations may cause the exempt CFC to have a built-in gain or loss in its interest in the exempt partnership and related to the partnership's functional currency, while the exempt partnership has no built-in gain or loss in its own functional currency. It appears that an adjustment arising from such currency fluctuations would then be allocated to assets other than the partnership's own functional currency, potentially resulting in the recognition of additional gain or loss on the sale or exchange of those assets or in more or less amortization and depreciation. These adjustments based on currency fluctuations seem inappropriate if both the CFC and partnership are exempt from Section 987(3).

Example 3: Section 743(b) Adjustment

Exempt CFC owns 99% of an exempt lower-tier partnership ("LTP"). The CFC has a pound functional currency, and the LTP has a euro functional currency. When the pound:euro exchange rate is 1:0.8, CFC contributes £100 to LTP, which uses it to buy €60 and land worth €20. CFC's basis in LTP is £100. LTP has a Section 754 election in effect.

At a time when the pound:euro exchange rate is 1:1 and the land has appreciated to €25, and all of the appreciation in partnership assets is allocable to CFC, CFC contributes the interest in LTP to an upper-tier partnership ("UTP"), which has a pound functional currency, and receives in exchange a 99% interest in the UTP.

Does UTP have a Section 743(b) adjustment with respect to the LTP interest?[39] A Section 743(b) adjustment is generally calculated as a partner's basis in the partnership interest (here, CFC's basis in LTP is £100) minus the partner's share of basis of the partnership assets.[40] The latter is calculated as the amount the partner would receive on liquidation (here, €85 in currency and land, which is worth £85 in UTP's currency at the exchange rate at the time of the distribution)[41] minus the gain (or plus the loss) that would be allocated to the UTP upon LTP's sale of its assets.[42] Here, LTP would recognize €5 of gain on the sale of its land and no gain on the sale of its currency. At the current exchange rates, the €5 gain would be translated to £5. Therefore, it appears that UTP would have a

[39] In this fact pattern, if the CFC and LTP had the same functional currency, the contribution of the LTP interest to UTP would not result in a Section 743(b) adjustment, because UTP would have the same gain in its LTP interest (attributable to the appreciation in the land) as LTP would have in its assets.

[40] See Treas. Reg. § 1.743-1(b).

[41] Although it is not entirely clear that the current exchange rates ought to be used, this seems most appropriate in calculating the amount that UTP would receive on liquidation and the gain that UTP would be allocated (the latter of which would have to be translated using exchange rates at the time of the hypothetical sale).

[42] See Treas. Reg. § 1.743-1(d).

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Section 743(b) adjustment of £20 (£100 outside basis – (£85 value on liquidation - £5 gain in land)).[43]

Assuming UTP has a Section 743(b) adjustment with respect to its interest in LTP, it is not clear to which assets it is allocated and in what currency. LTP has built-in gain of €5 in the land, and no other property, other than its own functional currency.[44] Therefore, it appears that the entire positive adjustment would be allocated to the land.[45] It is not clear whether this adjustment would be in euros or pounds. If the land were sold for €25 immediately after this contribution, UTP would be allocated €5 of gain (translated to £5 at the exchange rate at the time of sale) and would recover its £20 adjustment for a loss of £15. If instead the land were depreciable property, the Section 743(b) adjustment—representing the net of CFC's foreign currency loss and its share of economic gain in the property—could be recovered as depreciation.

It does not appear appropriate to allow for Section 743(b) adjustments that arise solely from foreign currency fluctuations, because in general the partner's foreign currency related built-in gain or loss in its partnership interest is attributable to an asset (the partnership's functional currency) that does not have built-in gain or loss in the partnership's hands. Thus, the foreign-currency-related gain or loss in the partnership interest would always give rise to an adjustment in a partnership asset other than the foreign currency itself, a result that seems distortive. This result seems even less appropriate in the case of a CFC and partnership that are both exempt from Section 987(3).

The Treasury and IRS could consider proposing special rules to eliminate the foreign currency related adjustment, by reducing the Section 743(b) adjustment that would otherwise be calculated by the net unrecognized Section 987 loss (or increasing it by the net unrecognized Section 987 gain), in each case calculated using equity and basis pool concepts as set forth in Notice 2026-17. In Example 3, the UTP's equity pool with respect to its partnership interest in LTP would be £80 (€80 contribution in LTP's functional currency/€1 current spot rate) and its basis pool would be £100, so its net unrecognized Section 987 loss would be £20. Any such special rules would of course reintroduce some complexity that Treasury and the IRS tried to eliminate with the CFC Election. We note, however, that such special rules would be consistent with our suggestion to consider allowing certain partnerships to elect out of Section 987(3) if the partners use an equity and basis pool method to track unrecognized Section 987 gain or loss with respect to their partnership interests.[46]

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[43] This is equal to the foreign currency loss of approximately £20 inherent in LTP's euro-denominated investments relative to UTP's pound foreign currency and reflects the fact that if UTP sold its interest in LTP, it would recognize a loss of £15 but if LTP sold its assets, UTP would be allocated a gain of £5.

[44] We do not believe that a Section 743(b) adjustment can be made to LTP's own functional currency, which is "money" rather than property from LTP's perspective.

[45] See Treas. Reg. § 1.755-1(b)(5).

[46] Adjustments to the equity and basis pool concepts would be needed in the case of a partnership that has QBUs with different functional currencies, or a QBU with a functional currency different from that of the partnership.

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Example 4: Section 734(b) Adjustment

The facts are the same as in Example 3, except that at a time when the pound:euro exchange rate is 1:0.5 and the land is still worth €20, LTP distributes €60 to CFC. These €60 are worth £120 in CFC's hands.

For purposes of applying Section 732, it appears that the euros would be distributed to the CFC with a basis translated at the current spot rate. Thus, they would have basis of £120 from the CFC's perspective. However, because the CFC's basis in LTP is only £100, the CFC would take the €60 with a basis of £100 under Section 732(a)(2), and would reduce its basis in LTP to £0. A Section 734(b) adjustment of £20 would arise with respect to LTP. Generally this adjustment would need to be allocated to property with a character similar to the character of the property distributed.[47] Assuming it cannot be allocated to the euros (which are the LTP's own functional currency), it would be allocated to the land, effectively creating a built-in loss in the land. As above, this seems distortive, potentially allowing the CFC to recognize a loss on sale of the land (while continuing to hold the distributed euros with a built-in gain).

This Section 734(b) basis adjustment resulting from foreign currency fluctuations might be avoided if the euros are distributed with a basis (in pounds, in the CFC's hands) translated at the historic rate. In this simple example, an equivalent result could be reached if the CFC keeps equity and basis pools with respect to its interest in LTP, and those pools are used to determine the basis of the distributed euros. The CFC's equity pool with respect to its interest in LTP would be £160 (€80 contribution/€.50 current spot rate) and its basis pool would be £100. Therefore, its unrecognized Section 987 gain is £60. In this case, the distribution represents 75% of the value of the CFC's historic investment in LTP. If 75% of its unrecognized Section 987 gain (£45) is recovered to reduce the basis in the distributed euros, their basis would be £75 (the equivalent of translating the euro basis at the historic exchange rate), and there would be no Section 734(b) adjustment. CFC's basis in its LTP interest would be £25 after the distribution, and its basis and equity pools would be adjusted accordingly.[48] These adjustments, however, would become significantly more complicated if the CFC made additional investments or the LTP earns income or has losses, in each case at times when the pound:euro exchange rate is different. A simpler adjustment that might be considered would be to adjust the basis of distributed LTP currency (euros in this case) only if their basis at the current spot rate would exceed the partner's basis in the LTP, and then only to the extent of the partner's unrecognized Section 987 gain with respect to its partnership interest (as determined using an equity and basis pool method).

V. Recommendations related to the 2024 Final Regulations and Partnerships

Except in certain limited regards, the 2024 Final Regulations do not apply to partnerships. Instead, the regulations recognize two approaches to partnerships labeled entity and

[47] See Treas. Reg. § 1.755-1(c).

[48] Adjustments to the equity and basis pool concepts would be needed in the case of a partnership that has QBUs with different functional currencies, or a QBU with a functional currency different from that of the partnership.

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aggregate and instruct taxpayers to act "reasonably" in applying Section 987.[49] Allowing taxpayers to choose their method of reporting reflects the difficulty in applying Section 987 to partnerships. Indeed, as the preamble to the 2024 Final Regulations states: "The Treasury Department and the IRS have determined that, without additional guidance, the Section 987 regulations in their entirety could not be applied to partnerships in an administrable way."[50] Further, "Pending future guidance, taxpayers must apply sections 987 and 989(a) with respect to partnerships using *a reasonable method* consistent with the statute." (Emphasis added.)[51]

We recognize this difficulty and agree that further guidance, even if not in the form of regulations, would be helpful. This report does not comment generally on the various approaches that might be taken by partnerships and partners to apply Section 987, but identifies several targeted areas in which additional guidance or changes to the 2024 Final Regulations would be helpful.

A. Election into Simpler Application of Section 987(3) for Certain Partnerships in which Partners Use an Equity and Basis Pool Method to Track a Deferred Section 987(3) Amount with respect to Their Partnership Interests

We recommend that Treasury and the IRS consider allowing a partnership operating solely in one functional currency (whether directly or through one or more QBUs with that functional currency)[52] to elect into a simpler application of Section 987(3), provided that the partners agree to apply an equity and basis pool method with respect to their partnership interests. The equity and basis pool method would be similar to the one described in Notice 2026-17, but with certain modifications specific to partnerships. Upon a sale or disposition, or a distribution resulting in gain recognition, the partner would recognize a proportionate portion of its unrecognized Section 987 gain or loss in the partnership interest and, as a result, recharacterize a portion of the recognized gain or loss as ordinary income or loss. This partnership election would simplify the application of Section 987 to partnerships and eliminate the complexity of tracking remittances and historical exchange rates while preventing the shifting of unrecognized Section 987 gain and loss among partners. As with the CFC Election,

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[49] Treas. Reg. § 1.987-7.

[50] Preamble, Summary of Comments and Explanation of Revisions, Section (II)(A)(2).

[51] Preamble, Summary of Comments and Explanation of Revisions, Section (VIII)(B)(1).

[52] We have proposed limiting this election to a partnership with a single functional currency (or to a partnership that has QBUs operating only in one functional currency) for two reasons. First, the complications that arise in applying Section 987(3) to partnerships exist mainly as between the partnership and its partners, because the rules in the 2024 Final Regulations generally assume a single owner of a QBU. The same complication does not exist as between a partnership and a QBU owned solely by that partnership. Second, there is not a simple way to apply an equity and basis pool method with respect to a partnership interest if the partnership has multiple QBUs with different functional currencies, unless some translation is made within the partnership itself. This latter point is discussed further at the end of this section. As a result, this election would not be available to a partnership that both operates a business in dollars in the United States and another business (in a functional currency other than the dollar) outside of the United States.

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partnerships that make the election would still be required to continue to apply the rules of Section 987(1) and (2) for purposes of computing the taxable income of the partnership.

Under the 2024 Final Regulations, partnerships are required to apply Section 987(3) in a reasonable manner using a method that is applied consistently with respect to a particular partnership or each eligible QBU of the partnership.[53] Despite this flexibility in application of Section 987(3), most reasonable methods still result in significant complexity and require significant recordkeeping and information reporting by the partnership, including the necessity to track historic exchange rates with respect to historic assets and potentially maintaining partner-level pools of unrecognized Section 987 gain or loss with annual adjustments. Transfers between the partnership and any of its own QBUs must also be tracked and treated as recognition events, requiring complex calculations to determine the appropriate remittance proportion and thus the amount of unrecognized Section 987 gain or loss to recognize. The IRS and Treasury have also noted that some methods that are otherwise reasonable may allow for transfers of ordinary income and losses among partners. In short, the application of Section 987(3) as between a partnership and its partners is difficult to reconcile with subchapter K rules. Furthermore, the unrecognized Section 987 gain or loss can be preserved in a partner's outside basis in the partnership using equity and basis pools. Thus, while we recognize and acknowledge the concern regarding the deferral of foreign currency gain or loss, a simplified approach utilizing equity and basis pools at the partner level strikes a balance between simplicity and accuracy and utilizes tools already familiar to many partnerships and tax practitioners.

The equity and basis pool method proposed in Notice 2026-17 may need to be modified for partnership interests. For example, it may be appropriate to incorporate Section 704(b) and Section 704(c) concepts to ensure that the pools appropriately track the partner's share of unrecognized foreign currency gain or loss. The equity pool would be maintained in the partnership's functional currency and would be adjusted using rules similar to the Section 704(b) rules for capital account maintenance. For example, the equity pool should be increased by the fair market value (which will equal the initial Section 704(b) value) of property contributed, not the basis of the property contributed. Contributions and distributions would be translated at the spot rate on the date of the transfer, based on the fair market value on the date of transfer (which will equal the Section 704(b) value at the time of transfer). The basis pool would be maintained in the functional currency of the partner and adjustments would be made in the same manner as outlined in Notice 2026-17, but should also be increased for a partner's share of Section 704(c) layers.[54] Any Section 704(c) forward layer would be tracked in the partner's functional currency as part of the partner's basis pool, but also in the functional currency of the QBU for purposes of partnership allocations.

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[53] Treas. Reg. § 1.987-7(b).

[54] By including the full Section 704(b) value in the equity pool (rather than just the basis) and the Section 704(c) layer (which is the excess of fair market value over basis) in the basis pool, a property's built-in gain or loss at the time of contribution is included in both pools, allowing the equity and basis pool method to track appropriately currency gain or loss with respect to the Section 704(c) layers.

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Under this method, a remittance by a QBU to the partnership would not result in recognition of Section 987 gain or loss, but instead Section 987 gain or loss would only be recognized by a partner in the event of a sale or disposition of the partnership interest or a distribution that results in gain or loss.[55] For example, upon a taxable sale of a portion of the interest, a corresponding amount of unrealized Section 987 gain or loss (proportionate to the percentage of the interest sold) would be recognized, the partner's basis in the partnership interest would be increased or decreased accordingly, and the gain or loss on sale would then be calculated.[56] A partner would make annual adjustments to its equity and basis pools and upon an event that requires recognition of a part of the partner's unrecognized Section 987 gain or loss.

The following example demonstrates the potential application of the partnership equity and basis pool method with these adjustments.

> **Example 5**. Partner A and Partner B, each a domestic entity, form PRS, a foreign partnership. PRS conducts all its operations through an eligible QBU with a euro functional currency. Partner A contributes land to PRS with fair market value of $120 and adjusted basis of $100 while Partner B contributes $120 of cash at a time when the dollar:euro exchange rate is 1:1.25. The partnership uses the $120 to buy €150. As a result, each of Partner A and Partner B begins with a Section 704(b) equity pool of €150. Partner A's initial basis pool includes the $100 of basis of the land contributed plus the $20 built-in gain in the land for a total of $120. Partner B's initial basis pool is $120 from the contribution of cash. Partner A's Section 704(c) forward layer inside the partnership is €25. Partner A and Partner B also have an adjusted outside basis, always maintained in the functional currency of the partner, of $100 and $120, respectively. At the end of Year 1, Partner A and Partner B's unrealized Section 987 gain or loss is $0 (for purposes of this example assume the yearly average exchange rate and the spot rate on the last day of the taxable year are the same).
>
> In Year 2 the QBU earns €100 when the dollar:euro yearly average exchange rate is 1:1.1. As a result, each of Partner A and Partner B is allocated €50, or $45.50 and their equity and basis pools are increased accordingly (Partner A: equity pool - €200, basis pool – $165.50; Partner B: equity pool - €200, basis pool - $165.50) and the basis in their partnership interests are increased by $45.50. The QBU uses the €100 to buy stock. The QBU then sells the land for €150, recognizing €25 (€150 consideration less the basis in the hands of the QBU of €125). All €25 is allocated to Partner A under Section 704(c), and the gain is translated to $22.70. Partner A's equity pool remains unchanged as equity pools are maintained under the principles of Section 704(b) and the sale does not result in

[55] Treasury and the IRS should consider whether to defer accelerated loss recognition in the case of related party sales.

[56] Treas. Reg. § 1.751-1(a)(1) uses a similar framework when a portion of the gain or loss from sale of a partnership interest is recharacterized as ordinary. We recommend that Treasury and the IRS consider the appropriate rules in the case of a tax-deferred disposition of a partnership interest, for example a contribution of a partnership interest to a corporation in a Section 351 transaction or to another partnership in a Section 721 transaction.

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Section 704(b) gain or loss. Partner A's basis pool is reduced by $20 for the elimination of the Section 704(c) forward layer but increased by $22.70 for the gain recognized. Partner A's outside basis is increased by $22.70 to $168.20. At the end of Year 2, Partner A's unrecognized Section 987 gain or loss is $13.62 (equity pool of €200 translated at the spot rate less the basis pool of $168.20), and Partner B's unrecognized Section 987 gain or loss is $16.32 (equity pool of €200 translated at the spot rate less the basis pool of $165.50). The partnership holds €300 and stock worth €100.

In Year 3, when the dollar:euro yearly average exchange rate is 1:1.1 and the stock has increased in value to €120, Partner A sells 50% of its interest to Partner C for $95.45 recognizing gain of $11.35.[57] As a result, Partner A should recognize a proportionate share of its unrecognized Section 987 gain or loss, or $6.81. Thus, of the $11.35 Partner A recognized from the sale of a portion of its partnership interest, $6.81 would be recharacterized as ordinary income under Section 987. Subject to the application of other U.S. federal income tax provisions, the remaining $4.54 would be capital gain.

Upon a distribution of money from the partnership, to the extent the partner recognizes gain under section 731(a), we recommend that a corresponding amount of the unrealized Section 987 gain or loss (based on the ratio of the section 731(a) gain recognized to the total built-in gain in the partnership interest) be recognized. This is demonstrated by the following example:

Example 6. The facts are the same as in Example 5, but assume instead that in year 3, when the dollar:euro yearly average exchange rate is 1:1.1, and the stock has increased in value to €120, PRS exchanges €105 for $95.45, which it distributes to Partner A in redemption of half of Partner A's interest. Partner A's basis immediately before this distribution is $168.20, so Partner A does not recognize gain under section 731(a). The built-in gain in Partner A's remaining interest is $22.71, more than its unrecognized Section 987 gain or loss of $13.61.[58] In this circumstance, because Partner A does not otherwise recognize gain as a result of the distribution of money, we believe it is appropriate not to require recognition of any of Partner A's unrecognized Section 987(3) amount in its partnership interest. This result is consistent with the general structure of the distribution rules under Subchapter K, in which a partner recovers basis in its partnership interest on a dollar-for-dollar basis when it receives distributions of cash.

Instead assume that PRS exchanges €187 for $170, which it distributes to Partner A in redemption of a portion of Partner A's interest. Partner A recognizes gain of $1.80, which represents 7.93% of Partner A's total gain in its partnership interest. Thus, under this

[57] The partnership's assets at this point include €300 and stock worth €120, which are worth $381.81 at the current spot rate. Half of Partner A's interest is therefore worth $95.45. Partner A's basis at the time of sale is $168.20, half of which is $84.10.

[58] The value of Partner A's interest before this distribution is $191, and it is reduced to $95.45 as a result of the distribution. The basis of Partner A's interest before the distribution is $168.20, and it is reduced to $72.75. Partner A's equity and basis pools would both be reduced by $95.45, leaving the unrecognized Section 987 gain unchanged at $13.62.

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method, Partner A would recognize $1.08[59] of its unrecognized Section 987(3) gain with respect to the distribution, the remaining gain of $0.72 would be capital. Partner A's equity and basis pools would be adjusted accordingly to reflect remaining unrecognized Section 987(3) gain of $12.54.

To the extent the partner's Section 987 gain exceeds the gain in the partnership interest, the Section 987 gain recognized would exceed the actual gain recognized, and thus the partner would recognize the proportionate amount of Section 987 gain and a capital loss.

If a partner has a built-in gain in its partnership interest, but an unrecognized Section 987(3) loss, a sale of the partnership interest would be expected to generate an ordinary loss and a larger capital gain.[60] For example, if the partner's total built-in gain in its partnership interest is $100, but the partner also has an unrecognized Section 987(3) loss of $20, and the partner sells the entire interest, the partner would recognize an ordinary loss of $20, and a capital gain of $120. Consistent with the examples above, distributions of money that result in gain recognition under section 731(a) would also trigger a portion of the unrecognized Section 987(3) loss.

Special rules would likely be needed for distributions of property, and in particular distributions of property in liquidation of a partner's partnership interest. Although the partner's basis in the property would be limited to the partner's basis in the partnership interest (thus no importation of higher basis would result),[61] rules would likely be necessary to preserve the character of the unrecognized Section 987 gain or loss. For example, if a partner who has a partnership interest worth $100 with basis of $120 and unrecognized Section 987(3) gain of $30 sold the partnership interest for $100, the partner would recognize ordinary income of $30 and a capital loss of $50 under the rules suggested above. If instead the partner received a distribution of land worth $100 in liquidation of its partnership interest, the partner would generally take the land with basis of $120, and without special rules, the unrecognized Section 987(3) gain would be lost. We think there are generally two alternatives in this situation: the rules could require immediate recognition of the Section 987 gain or loss inherent in the partnership interest or they could provide for a carryover of the inherent Section 987 gain or loss to the property, to be recognized when the property is sold. It would also need to be determined how these rules would apply on a non-liquidating distribution of property to a partner.

As these examples demonstrate, allowing certain partnerships to elect into a simpler application of Section 987(3) and apply a modified equity and basis pool method does not allow partners to escape Section 987 gain or loss (assuming Treasury adopts additional rules relating to property distributions as noted above), nor does it allow Section 987 gain or loss to shift inappropriately among partners. This election would provide a simplified method for partners and partnerships to track unrealized Section 987 gain and loss without the need for complex recordkeeping with respect to historic exchange rates and historic items and without the need to

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[59] This is 7.93% of Partner A's unrecognized Section 987(3) amount of $13.61.

[60] Section 741. For simplicity, it is assumed that Section 751(a) will not apply to recharacterize any capital gain recognized on the sale of the partnership interest to ordinary income.

[61] Section 732(b).

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track remittances by QBUs. If the election is made by a partnership for a taxable year, we propose that the partnership would be required to apply the method to all future taxable years of the partnership with respect to all of its QBUs. If, in a subsequent taxable year of the partnership, the partnership becomes ineligible for the election, for instance, because of the contribution of a QBU with a different functional currency from the existing QBUs of the partnership, we recommend that the partners be deemed to have disposed of their partnership interest for purposes of Section 987, thereby causing recognition of any unrecognized Section 987 gain or loss. This would give the partners and the partnership a clean slate to apply Section 987(3) going forward using a reasonable method as required by the regulations.

The mechanics of a partnership exemption election would need to be determined. For example, it is not clear whether it ought to require consent of all the partners, who would be required to maintain equity and basis pools with respect to their own interests. Consideration would also need to be given to operation of the election with tiered partnerships. For example, if the election is made by a partner that is itself a partnership, presumably its partners would also need to maintain corresponding equity and basis pools in their partnership interests.

Finally, we have proposed limiting this election to a partnership with a single functional currency (or operating QBUs solely in one functional currency),[62] in part because we do not believe there is a simple way to apply an equity and basis pool method with respect to a partnership interest if the partnership has multiple QBUs with different functional currencies. To take a simple example, assume that at the end of year 1, when the pound:dollar:euro exchange rate is 1:1:1, two partners contribute a total of $100 to a partnership that has a euro functional currency and that operates two QBUs, one with a euro functional currency and one with a pound functional currency. The partnership invests €50 in one QBU and £50 in the other. At the end of the second year, when the pound:dollar:euro exchange rate is 1.2:1:0.5, and the partnership assets have neither appreciated or depreciated in their own local currency, the partners' interests are worth $141.67 in the aggregate (the €50 investment is worth $100 and the £50 is worth $41.67), which includes a net $41.67 foreign currency gain. Using the method suggested by Notice 2026-17, the partners' total equity pool would be $200 (€100 investment translated into dollars at the current spot rate) and the basis pool would be $100, suggesting a foreign currency gain of $100. This does not account for the fact that half of the original investment was made in pounds, which then depreciated relative to the dollar. Additional rules would be necessary to adjust the equity and basis pools to account for both currencies, but this may introduce significant complication. In effect, the items of any QBU in a functional currency other than the partnership's (or other than the largest QBU) could be translated annually into the partnership's (or largest QBU's) functional currency and then into the partner's equity pool. In this example, the partners invested €50 in the euro QBU and £50 in the pound QBU. At the end of each year, the "equity pool" of the pound investment would be translated first into euros at the applicable rate, and then into dollars. In this example, it would be $41.67 (£50/£1.2 * €0.5) at the end of the second year. The equity pool with respect to the euro investment would be $100. In total, the partners' equity pool

[62] For this purpose, tiered partnerships should be looked through, such that if an upper-tier partnership has a pound functional currency and owns an interest in a lower-tier partnership with a euro functional currency, the partners in the upper-tier partnership would not be able to make this election.

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is $141.67, which accurately reflects the net foreign currency gain with respect to the partnership. This method, however, would require tracking separately whether a partner's contribution is invested in the pound QBU or the euro QBU, and would require adjustments for transfers between the QBUs. Thus, it is not clear that it would be materially simpler compared to the existing rules under the 2024 Final Regulations.

B. Election Out of Section 987(3) for Certain Partnerships for which Capital Is Not a Material Income Producing Factor

We recommend that Treasury and the IRS consider guidance providing for certain partnerships for which capital is not a material income-producing factor to elect out of Section 987(3). This election should not require the partners' use of equity and basis pool methods with respect to their partnership interests, and neither the partnership nor the partners would track unrecognized Section 987 gain or loss. The electing partnership, however, should still be required to apply sections 987(1) and (2) for purposes of computing the partnership's taxable income.

In general, the 2024 Final Regulations implementing Section 987(3) ensure that a QBU owner recognizes the foreign exchange rate fluctuations attributable to certain marked assets when remittances are made from a QBU. As discussed above, the balance sheet approach in the 2024 Final Regulations was intended to distinguish between property whose value is highly responsive to exchange rate fluctuations (including, for example, the functional currency of the owner) and property for which exchange rate changes have only remote or uncertain effect on value (for example, the goodwill of a service business).

Most partnerships for which capital is not a material income-producing factor (and their QBUs) do not hold large amounts of currency or other marked assets, but rather distribute cash on a current basis. As a result, neither the partnership nor the partners would accumulate significant unrecognized Section 987 gain or loss year over year. Furthermore, the income generated by these businesses is already characterized as ordinary income, regardless of whether the partnership engages in a business through a QBU. As a result, the mechanisms of Section 987(3) whereby the currency fluctuations are separated from underlying increases or decreases in asset value would have no impact on the ultimate taxation of the income generated by the partnership. These partnerships for which capital is not a material income-producing factor should not be required to undertake the extensive recordkeeping that might be required to track unrecognized Section 987 gain or loss, when little or no actual change in the taxation of the partnership operations will result. That is, they should be allowed to elect out of the application of Section 987(3) altogether.

We recommend that the election be available only to partnerships that do not accumulate marked assets beyond the reasonable needs of the business. However, such an election should not be limited to partnerships that do not own any capital or Section 1231 assets. For example, while partnerships that primarily perform services typically have investments in office space, equipment, and other assets necessary to aid in the provision of services, these assets are not typically held to generate income directly but rather are held in furtherance of the provision of services. Furthermore, generally partners who leave these types of partnerships do not recognize capital gain resulting from their share of the partnership's investment in these capital assets, thus

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there is no theoretical conversion of ordinary income (if any of the capital assets were held by a separate QBU of the partnership) to capital gain. If a partnership were to invest heavily in capital or Section 1231 assets for generation of income, and such assets were held in a QBU with a different functional currency, the election out of Section 987(3) may no longer be appropriate.

C. Partnership Elections

Of the various elections permitted by the 2024 Final Regulations, only two are specifically listed as elections permitted to be made by partnerships.[63] The 2024 Final Regulations permit other taxpayers to make at least eight other types of elections.[64] In certain cases, it appears that a partnership might take an approach that is consistent with one of these other types of elections as part of its "reasonable method." For example, a CFC with multiple QBUs with the same functional currency may make a grouping election to treat these as a single QBU for purposes of applying Section 987. The grouping election is not specifically listed in Treas. Reg. § 1.987-7 as an election to be made by a partnership, but a partnership with multiple QBUs with the same functional currency may apply a reasonable method that treats these as one QBU for purposes of applying Section 987. It would be helpful for the IRS and Treasury to clarify in this situation whether the partnership needs to make a formal election or report on IRS Form 8964-ELE any "quasi elections" that are part of its reasonable method.

[63] The two permitted to be made by partnerships are the annual recognition election and the Section 988 mark to market election in Treas. Reg. § 1.987-7(c)(2)(ii) and (iii).

[64] These include the Section 987 current rate election under Treas. Reg. § 1.987-1(d)(2), the Section 987 grouping election under Treas. Reg. § 1.987-1(b)(3)(ii), the election to use a spot rate convention under Treas. Reg. § 1.987-1(c)(1)(ii), the election to use the historic inventory method under Treas. Reg. § 1.987-3(c)(2)(iv)(B), the amortization and small business exemptions in the transition rules under Treas. Reg. § 1.987-10(e)(5)(ii)(A) and -10(e)(7)(iv), the election to recharacterize certain Section 987 gain or loss as foreign currency gain or loss transactions under Treas. Reg. § 1.987-6(b)(2)(i)(C)(*1*), and the recurring transfer group election under Prop. Treas. Reg. § 1.987-2(f)(1).

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