



US International Tax Alert

IRS, Treasury release proposed regulations under section 987 and related rules

On November 9, 2023, the IRS and Treasury released proposed currency regulations under section 987 and related rules (the “2023 Proposed Regulations”). Section 987 applies to taxpayers with a qualified business unit (QBU) in the form of a disregarded entity, branch, partnership, trust, or estate, if the QBU has a functional currency that is different from the functional currency of its tax owner(s) (a “Section 987 QBU”). Section 987 addresses foreign currency translation related to operations, assets, and liabilities of Section 987 QBUs, and provides rules for:

1. Computing taxable income (and associated earnings and profits) of the Section 987 QBU,
2. Recognizing currency gain or loss, and
3. Translating basis in property that is transferred to or from a Section 987 QBU.

The 2023 Proposed Regulations are based on the final section 987 regulations issued in 2016 and 2019 (the “2016 Regulations” and “2019 Regulations,” respectively, and together, the “Final Regulations”), but contain significant changes that include modifying, removing, or adding rules under sections 985 through 989, as well as under sections 861 and 1502. The 2023 Proposed Regulations would apply to a broader group of taxpayers than the Final Regulations. The 2023 Proposed Regulations would (like the Final Regulations) significantly change the way most taxpayers currently make computations for Section 987 QBUs.

In this alert, we summarize the highlights of the 2023 Proposed Regulations.

Applicability date and coordination with other guidance

- The 2023 Proposed Regulations amend the Final Regulations (including their applicability date) and, if finalized, would apply to taxable years beginning on or after December 31, 2024.¹ When finalized, the 2023 Proposed Regulations would also have a retroactive effect for certain QBUs that terminate on or after November 9, 2023 (“terminating QBUs”).
- According to the preamble, a taxpayer can rely on the 2023 Proposed Regulations (including the delayed applicability date of the regulations), if the taxpayer and each member of its consolidated group and section 987 electing group² consistently “follows” the 2023 Proposed Regulations in their entirety.

¹ (2023) Prop. Reg. §1.987-14(a)(1).

² A section 987 electing group is defined to include (i) the relevant US person; (ii) each controlled foreign corporation (CFC) in which the relevant US person owns (within the meaning of section 958(a)) more than 50% (by vote or value); (iii) each foreign partnership in which the relevant US

- By properly relying on the 2023 Proposed Regulations, taxpayers effectively can delay the application of the Final Regulations (for calendar year taxpayers—to January 1, 2025). Recall that the Final Regulations were scheduled to apply to taxable years beginning after December 7, 2023³; thus, for calendar year taxpayers, the Final Regulations were scheduled to take effect on January 1, 2024.
- While it is not entirely clear, the reliance language in the preamble may mean that *taxpayers who rely* on the 2023 Proposed Regulations to delay the applicability of the Final Regulations are *committing* to applying the 2023 Proposed Regulations on their scheduled applicability date (*i.e.*, for calendar year taxpayers, January 1, 2025) regardless of whether the 2023 Proposed Regulations are actually finalized. On the other hand, *taxpayers who do not rely* on the 2023 Proposed Regulations arguably are required to transition to the Final Regulations on their scheduled applicability date (*i.e.*, for calendar year taxpayers, January 1, 2024).
- In addition, taxpayers can (but are not required to) adopt the 2023 Proposed Regulations early, *i.e.*, for taxable years ending after November 9, 2023, and beginning on or before December 31, 2024, provided that the taxpayer's US consolidated group and section 987 electing group follow the regulations in their entirety and in a consistent manner.⁴
- Taxpayers also can adopt the Final Regulations for taxable years beginning after December 7, 2016, and beginning on or before December 31, 2024, provided that the taxpayer (including members in its consolidated group and section 987 electing group⁵) first applied the Final Regulations to a taxable year ending before November 9, 2023, and has consistently applied such regulations in their entirety to all Section 987 QBUs.⁶ Only taxpayers who first applied the Final Regulations on the tax return filed prior to November 9, 2023 can adopt the fresh start transition method in the Final Regulations; otherwise, the new transition method must apply.⁷ Taxpayers who—by the time the 2023 Proposed Regulations were released—had already undergone the fresh start transition and filed a tax return reflecting such transition can continue to apply the Final Regulations using the fresh start method.

person owns (directly or indirectly) more than 50% of the capital and profits interest; and (iv) each foreign non-grantor trust or estate in which the relevant US person's beneficial interests in the trust or estate exceed 50%.

³ Notice 2022-34, 2022-34 I.R.B. 150 (Aug. 22, 2022).

⁴ (2023) Prop. Reg. §1.987-14(b).

⁵ The section 987 electing group for this purpose is defined in (2023) Prop. Reg. §1.987-14(c)(3).

⁶ (2023) Prop. Reg. §1.987-14(c)(1)(i) and (ii).

⁷ (2003) Prop. Reg. § 1.987-14(c)(1)(iii).

Observations:

- The preamble to the 2023 Proposed Regulations states that the “proposed regulations also provide rules regarding the applicability dates of the final regulations and temporary regulations.” The preamble also states that “[b]ecause the proposed regulations would replace or modify parts of the final regulations, the final regulations are not expected to become applicable in their current form.”
- Taxpayers should continue to apply Treas. Reg. §1.987-12 of the Final Regulations until the first taxable year to which they apply the 2023 Proposed Regulations.

Executive summary

Transition:

- No more fresh start transition—taxpayers must preserve pre-transition currency gains and losses.
- If the taxpayer has consistently applied a reasonable section 987 method before the transition date, pre-transition gains and losses are generally determined based on such method; otherwise, they are determined using a simplified approach provided in the 2023 Proposed Regulations.
- Taxpayers can elect to amortize pre-transition gains and losses over 10 years; absent such election, the pre-transition gain would be added to future unrecognized section 987 gain or loss, and the pre-transition loss would be subject to the suspended loss rules.

General approach of the 2023 Proposed Regulations:

- If finalized, would apply to most taxpayers, with very limited exceptions.
- Retain the distinction between marked and historic items in computing taxable income, earnings and profits, section 987 gain or loss, and tax basis, and the need to track historic rates and tax basis balance sheets.
- Retain most of the computational concepts in the Final Regulations, including the multi-step foreign exchange exposure pool (FEEP) method for computing section 987 gain/loss based on changes in net value of a QBU attributable to movement in exchange rates and the general remittances and termination concepts.
- Modify the deferral and outbound loss rules currently in effect.
- Provide two new key elections—current rate election and annual recognition election.
 - Current rate election:
 - Eliminates the need to use historic rates in any computation.
 - Generally requires certain section 987 losses to be suspended and recognized only to the extent of gains.
 - Annual recognition election:
 - Eliminates the need to use historic rates in computation of profit and loss (P&L).

- Generally requires/allows the taxpayer to recognize section 987 gain or loss every year.
 - Turns off the suspended loss rules and loss deferral rules with some exceptions.
- Some suspended losses may be lost permanently (*e.g.*, in inbound transactions, section 331 transactions).
- Retain deferral event and outbound loss rules but apply loss suspension concept with respect to outbound loss event rules.
- Retain modified section 988 rules adopted in the Final Regulations.
- Retain an aggregate approach to partnerships whose partners are 100% related and that conduct a trade or business.
- Apply an entity approach to other partnerships, with a hybrid approach to section 987 gain or loss where applicable.
- Provide coordination with certain consolidated return rules.
- Clarify rules for sourcing and characterizing section 987 gains and losses.

Transition

Fresh start method replaced:

- The “fresh start” transition method provided in the Final Regulations⁸ is no longer applicable under the 2023 Proposed Regulations, except for taxpayers who adopted the Final Regulations early.
- For purposes of determining unrecognized section 987 gain or loss in the first taxable year in which the 2023 Proposed Regulations apply, taxpayers will translate their beginning balance sheets using spot rates on the date before the transition date (*i.e.*, the first date of the taxable year to which the 2023 Proposed Regulations apply).⁹
- These spot rates generally also serve as “historic” rates for historic items on the balance sheet on the transition date.¹⁰

Observations:

- Using the spot rate as the historic rate for historic items on the books of the QBU on the transition date is meant to simplify the application of the FEEP methodology by eliminating the need to determine actual historic rates for such items.
- Translation of the beginning balance sheet at spot rates, together with the computation of the pre-transition section 987 gains and losses discussed below, appear generally to ensure that there are no permanent duplications or omissions of section 987 gains or losses upon transition.

Pre-transition section 987 gains and losses:

- Upon the transition to the 2023 Proposed Regulations, a taxpayer can preserve pre-transition section 987 gains or losses computed under its existing method if such existing method is an “eligible pre-transition

⁸ The fresh start transition method, described in Treas. Reg. §1.987-10, involves a deemed termination of a Section 987 QBU on the day before the transition date; however, no section 987 gain or loss would be recognized and all items on the balance sheet on the transition date would be translated using historic rates.

⁹ (2023) Prop. Reg. §1.987-10(d)(1).

¹⁰ (2023) Prop. Reg. §1.987-10(d)(2).

method,” and if the taxpayer applied such method reasonably and consistently each year (as applicable).¹¹

- An eligible pre-transition method includes but is not limited to the 1991 proposed regulations and the “earnings only” method (subject to certain limitations).
- A method to defer recognition of section 987 gain or loss until the termination of the QBU is not considered to be a reasonable method.
- A reasonable method includes any method that fully accounts for foreign currency gain or loss attributable to the assets and liabilities of a Section 987 QBU. The preamble states that an earnings-only method that uses a spot rate basis for certain distributions from a capital pool does not accurately measure an owner’s economic income. However, such method would be deemed reasonable if a taxpayer has applied the method on a tax return filed before November 9, 2023, and such method is consistently applied to all Section 987 QBUs of the same tax owner.¹²
- In the case of an eligible pre-transition method, the pre-transition section 987 gain or loss generally is equal to the section 987 gain or loss that would have been recognized with respect to the QBU under such method if it terminated on the day before the transition date and assuming that Treas. Reg. §1.987-12 does not apply to the resulting gain or loss.
 - This amount is adjusted further if—under the existing method—the basis of any assets or amounts of liabilities deemed distributed from the QBU upon such termination would be translated at a rate other than the spot rate on the date of such termination (*e.g.*, as in the case of the earnings-only method where distributions from capital are translated using historic rates).¹³
- Taxpayers who have not applied an eligible pre-transition method must compute pre-transition section 987 gains or losses using a simplified approach provided in the 2023 Proposed Regulations. Specifically, the pre-transition section 987 gain or loss in such case would be a section 987 gain or loss computed under the 2023 Proposed Regulations (treating all items as marked and simplifying the computation steps) reduced by any section 987 gain or loss actually recognized in the past with respect to the QBU.¹⁴
- Additional rules are provided for preserving gains or losses previously deferred under the deferral event and outbound loss event rules.
- Taxpayers who adopted the Final Regulations early and already underwent the fresh start transition method are not subject to the rules on pre-transition gains and losses.

¹¹ (2023) Prop. Reg. §1.987-10(e)(2)(i)(A).

¹² (2003) Prop. Reg. §1.987-10(e)(4)(iii). A taxpayer that begins applying this method on or after November 9, 2023 or fails to apply this method consistently to all of its section 987 QBUs, will not be treated as applying an eligible pre-transition method.

¹³ (2023) Prop. Reg. §1.987-10(e)(2).

¹⁴ (2023) Prop. Reg. §1.987-10(e)(3).

Observations:

- Taxpayers should examine whether their current section 987 computational methodology qualifies as an “eligible pre-transition method” that has been reasonably and consistently applied.
- Taxpayers who have not computed section 987 gain or loss in the past under an eligible pre-transition method or have not recognized such gain or loss consistently or otherwise did not apply such method reasonably, should consider establishing a reasonable method for computing section 987 gain or loss and address prior-year deficiencies, if any. Such taxpayers should also assess and compare the impact of computing the section 987 gain or loss under the simplified 2023 Proposed Regulations method.

Options for preserving pre-transition section 987 gains and losses:

- **Default rule:** Pre-transition section 987 gains are considered “unrecognized section 987 gains” and are added to the post-transition pool of section 987 gain or loss, essentially creating a beginning section 987 gain balance for the Section 987 QBU on the date of transition to be recognized under the regular rules or elections in the 2023 Proposed Regulations.
 - However, pre-transition section 987 losses are considered “suspended section 987 losses” and are subject to the suspended loss rules discussed below.¹⁵
- **Amortization election:** Under this election, pre-transition section 987 gains and losses can be recognized ratably over the 10-year period starting with the transition date.¹⁶ The suspended loss rule does not apply if a taxpayer makes this election. However, if a taxpayer makes this election, and engages in an inbound or outbound section 381(a) transaction, any remaining unrecognized pre-transition gain is immediately recognized, and any remaining unrecognized pre-transition loss is suspended under the suspended loss rules discussed below.
 - As discussed further below, in an inbound section 381(a) transaction, any suspended pre-transition loss not used under the loss-to-the-extent-of-gain rule (also discussed below), does not carry over and is thus permanently eliminated.

Terminating QBUs:

- If the 2023 Proposed Regulations become final, any Section 987 QBU terminated on or after November 9, 2023 (a terminating QBU), is subject to the 2023 Proposed Regulations (including the suspended loss rules, addressed below), which would apply immediately at the time of the termination (*i.e.*, there would be a retroactive effect potentially requiring an amended return in some cases).¹⁷

¹⁵ (2023) Prop. Reg. §1.987-10(e)(5)(i).

¹⁶ (2023) Prop. Reg. §1.987-10(e)(5)(ii).

¹⁷ (2023) Prop. Reg. §1.987-14(a)(2).

- A terminating QBU is defined as a Section 987 QBU that terminates on or after November 9, 2023 or terminates as a result of an entity classification election on Form 8832 that is filed after November 9, 2023, but is effective before November 9, 2023, and neither the 2023 Proposed Regulations nor the Final Regulations would apply with respect to the Section 987 QBU.¹⁸

Observations:

- Taxpayers should carefully consider potential section 987 effects with respect to any restructurings or entity classification elections made after November 9, 2023, where a Section 987 QBU potentially is terminated, as any section 987 loss of a terminating QBU may be subject to the suspended loss rules.

Scope

Covered persons:

- Any person (including an individual, corporation, partnership, S corporation, non-grantor trust, or estate) is subject to the 2023 Proposed Regulations, except foreign corporations that are not CFCs, CFCs without a US shareholder with section 958(a) ownership, foreign individuals, and certain *de minimis* owners.
- Specifically, with respect to *de minimis* owners, the 2023 Proposed Regulations do not apply to foreign non-grantor trusts, foreign estates, or foreign partnerships (other than section 987 aggregate partnerships) if US persons own, in the aggregate, less than a 10% interest in such trust, estate, or partnership.

Observations:

- Banks, insurance companies, RICs, REITs, etc. are now in scope.
- The 10% *de minimis* rule applies to US persons in the aggregate.

Definition of QBU and Eligible QBU:

- **QBU under section 989:** The 2023 Proposed Regulations retain the section 989 rule that a corporation, partnership (*other than* a section 987 aggregate partnership), trust, or estate is a QBU, and the activities of an individual, corporation, partnership, trust, or estate can also be a QBU. The QBU definition under section 989 is relevant for various tax purposes, including functional currency under section 985, nonfunctional currency transactions under section 988, etc.
- **QBU for purposes of section 987:** Under the 2023 Proposed Regulations, a corporation, partnership, section 987 aggregate partnership, trust, estate, or disregarded entity is not itself a QBU for purposes of section 987, but the activities of such entity may be a QBU.

¹⁸ (2023) Prop. Reg. §1.987-1(h).

- As a change from the Final Regulations, for purposes of section 987, if a corporation is solely engaged in activities that constitute a trade or business within the meaning of Treas. Reg. §1.989(a)-1(b)(2)(ii)(A), and the corporation maintains only one set of books and records, the activities (but not the corporation) are a QBU.¹⁹
- **Eligible QBU:** Is defined as a QBU (as defined for purposes of section 987) that is not subject to the US DASTM rules under Treas. Reg. §1.985-3.

Observations:

- Because a corporation can have an eligible QBU regardless of whether such eligible QBU is a Section 987 QBU to the corporation, the suspended loss rules can apply to a trade or business of a corporation even if such trade or business does not constitute a Section 987 QBU.
- The 2023 Proposed Regulations change the *per se* QBU rule for section 987 purposes. Note that a partnership with no trade or business activities is still a *per se* QBU under section 989 (and thus can adopt a functional currency under section 985 and determine section 988 gain or loss based on such currency). Under the 2023 Proposed Regulations, however, it is not a section 987 QBU.

Computation methodology

General approach for taxable income and section 987 gain or loss:

- The 2023 Proposed Regulations largely adopt the same general approach as the Final Regulations for computing the taxable income of the Section 987 QBU and computing the section 987 gain or loss using the FEET method.
- The 2023 Proposed Regulations also preserve most of the elections in the Final Regulations (*e.g.*, the QBU grouping election) with the exception of the Annual Deemed Termination Election, which has been replaced by the annual recognition election described below.
- The 2023 Proposed Regulations generally retain the computational rule of unrecognized and recognized section 987 gain or loss, including remittances, provided in the Final Regulations.²⁰
- Generally (subject to elections discussed below), the section 987 gain or loss is recognized upon a remittance or termination unless it is deferred under Treas. Reg. §1.987-12.
- The 2023 Proposed Regulations generally retain the attribution rules used to determine items on the books of a QBU for purposes of section 987; thus, non-portfolio stock held by a QBU and debt issued to acquire such stock continue to be treated as items not attributable to a QBU for purposes of section 987 (and 988).²¹
- The 2023 Proposed Regulations introduce a number of modifications and additional elections related to these computations.

¹⁹ (2023) Prop. Reg. §1.987-1(b)(4)(ii).

²⁰ (2023) Prop. Reg. §1.987-5.

²¹ (2023) Prop. Reg. §1.987-2.

Translation—the default approach:

- The default approach is still to differentiate between marked (monetary) and historic (non-monetary) items, resulting in section 987 gain or loss being significantly different than amounts reflected on financial statements as currency translation adjustments (CTA). As a general matter, marked items consist of cash, debt instruments, and accounts receivable and payable denominated in the QBU's functional currency.²² Marked items also include foreign currency derivatives that would be section 988 transactions in the hands of the owner and that are determined by reference to the functional currency of the QBU.²³ Special rules apply to inventory as well as section 988 transactions.
- In determining taxable income under the default approach, taxpayers must use historic foreign exchange (FX) rates to translate certain deductions and basis recovery, and current yearly average FX rates to translate the remaining items.²⁴
- In determining section 987 gain or loss using the multi-step FEED method under the default approach, taxpayers must use historic FX rates to translate historic items (*i.e.*, historic items at year end and transfers of historic items) and current spot FX rates for marked items (*i.e.*, year-end spot rates for year-end balances of marked items and applicable daily spot rates for transfers of marked items).²⁵
- In determining basis in items transferred from the QBU under the default approach, taxpayers must use historic FX rates to translate historic items and current spot FX rates to translate market items.²⁶
- The 2023 Proposed Regulations add new steps to the FEED methodology and more rules for attributing items to the books of a QBU. Thus, additional rules are provided for items of income and expenses that affect the income statement but not the balance sheet or vice versa.²⁷ A catch-all step also was added, requiring a computation of the residual change in value of the QBU measured in the QBU's functional currency unaccounted for by known earnings, transfers, and adjustments.²⁸

²² (2023) Prop. Treas. Reg. §1.987-1(d) & (e).

²³ *Id.*

²⁴ (2023) Prop. Reg. §§1.987-3, -1(c).

²⁵ (2023) Prop. Reg. §§1.987-4, -1(c).

²⁶ (2023) Prop. Reg. §§1.987-2(d) & -5(f)

²⁷ (2023) Prop. Reg. §1.987-4(d) Steps 7, 8, 9.

²⁸ (2023) Prop. Reg. §1.987-4(d) Step 10.

Observations:

- Any computations under section 987 must be done using a tax-basis balance sheet and tax-adjusted income statement, which includes, among other things, eliminating disregarded assets and liabilities (and disregarded income or expense). Thus, having proper and up-to-date tax-basis balance sheets is critical for complying with these rules.
- Under the default approach, taxpayers will be required to track the year in which the QBU acquired a particular historic item or placed it in service and to calculate depreciation, amortization, and basis recovery on an item-by-item basis.
- The new catch-all step in the FEED computation is helpful for taxpayers who do not have perfect input data (*e.g.*, transfers throughout the year, book-to-tax adjustments, etc.) and intends to catch amounts that otherwise could have created phantom section 987 gain or loss.

Elections

The 2023 Proposed Regulations retain most of the elections provided in the Final Regulations (*e.g.*, the grouping election) and added several important elections. The 2023 Proposed Regulations generally require consistency in all section 987 elections, such as the current rate election, the annual recognition election, as well as the election to amortize pre-transition gains and losses.

Current rate election:

- The new “current rate election” (CRE) allows taxpayers to treat all items owned by a Section 987 QBU as marked items, using current FX rates for all computations (taxable income, section 987 gain or loss, and basis upon transfers),²⁹ with the results generally resembling the results under the 1991 section 987 proposed regulations used by most taxpayers today.
- As a trade-off for making the CRE, taxpayers become subject to complex temporary and, in some cases, permanent “suspended loss” rules, discussed further below.
- The suspended loss rules that would apply due to the CRE effectively are turned off if the taxpayer concurrently makes an annual recognition election, as discussed below.
- If a taxpayer makes a CRE, the FEED method is simplified by eliminating certain steps.³⁰
- If a taxpayer revokes a CRE, special rules exist for establishing historic rates going forward.³¹

29 (2023) Prop. Reg. §1.987-1(d).

30 See (2023) Prop. Reg. §1.987-4(d).

31 See (2023) Prop. Reg. §§1.987-1(c)(i)(3)(F), -3(c)(3)(iii)(B).

Observations:

- The CRE would simplify the computation of taxable income and section 987 gain or loss but would implicate the complexity and impact of the suspended loss rules.
- The CRE would also change the amount of section 987 gain or loss. According to the preamble, making the CRE generally would increase the pool of unrecognized section 987 gain or loss vis-à-vis the default approach because historic items would be treated as marked, thus giving rise to additional section 987 gain or loss.
- Whether or not the CRE actually increases the pool of section 987 gain or loss (compared to the default approach) depends on the mix of assets and liabilities (historic vs. marked).¹

Annual recognition election:

- The new “annual recognition election” (ARE) allows taxpayers to recognize all unrecognized section 987 gain or loss on an annual basis.³² There is no deemed termination of a QBU as a result of making this election, and this election replaces the annual deemed termination election that was included in the Final Regulations.
- Regardless of whether the CRE is made, the ARE requires taxpayers to use current FX rates for all items in computing taxable income.³³ However, unlike the CRE, the ARE requires application of historic rates to historic items in computing section 987 gain or loss and translating basis upon transfers.³⁴ In such case, any difference between using the current FX rates for taxable income and historic FX rates for FEEP is captured as additional section 987 gain or loss.
- The ARE turns off the suspended loss rules with respect to losses that would otherwise have been suspended due to the CRE.³⁵
 - However, if the ARE is made, any previously unrecognized or deferred section 987 gain is recognized and any previously unrecognized or deferred section 987 loss becomes suspended loss if either such loss is above \$5 million or if there is a CRE in place at any point before (*i.e.*, “pre-ARE losses”).³⁶
- In spite of the ARE, the suspended loss rules would continue to apply to the suspended pre-transition losses or pre-ARE losses.³⁷ Such losses continue to be recognized under the modified loss-to-the-extent-of-gain rules discussed below.
- The ARE also turns off the deferral event rules under 2023 Prop. Reg. §1.987-12 and outbound loss rules (that convert the outbound loss into suspended loss) under 2023 Prop. Reg. §1.987-13.³⁸

³² (2023) Prop. Reg. (s) 1.987-5(b)(2).

³³ (2023) Prop. Reg. §1.987-2(c)(2).

³⁴ (2023) Prop. Reg. §§1.987-1(c)(3), -2(d)(2), 4 (d)&(e)(2)(ii), -5(f)(3).

³⁵ (2023) Prop. Reg. §1.987-11(e)(2).

³⁶ (2023) Prop. Reg. §1.987-11(d)(1).

³⁷ Recall also that an election is available in which a taxpayer may amortize pre-transition section 987 losses.

³⁸ (2023) Prop. Reg. §§1.987-12(a)(2)(i), -13(h).

Observations:

- Taxpayers should consider making the ARE if:
 - They wish to simplify their computations of taxable income but do not wish to potentially create (and recognize) additional section 987 gain or loss by treating historic items as marked under the CRE. In some cases, where the net marked assets or liabilities are not significant, the annual volatility of section 987 gain or loss may be a palatable trade-off for being able to compute taxable income without using historic rates.
 - They wish to apply the CRE but do not wish to deal with suspended loss rules associated with the CRE.
 - They wish to reduce the application of the deferral event rules in Treas. Reg. §1.987-12.
- If there is no CRE in place, the amount of income or deduction (including section 987 gain or loss recognized under the ARE regime) related to a historic item is the same regardless of whether the taxpayer makes the ARE.

The following matrix sets forth the coordination of the default rules and the two new elections at a high level.

	CRE	No CRE
ARE	Simplified: Current average rates used for all P&L, FEED, and basis on transfers	Semi-simplified: Current average rates used for all P&L, historic rates used for historic items in FEED and basis on transfers of historic items
	Increased exposure: 987 gain or loss on all items	Decreased exposure: 987 gain or loss on marked items
	Accelerated: Recognize section 987 gains and losses annually at end of taxable year	Accelerated: Recognize section 987 gains and losses annually at end of taxable year
	Suspended loss reduced: Suspended loss rules apply only to pre-transition and pre-ARE suspended losses	Suspended loss reduced: Suspended loss rules apply only to pre-transition and pre-ARE suspended losses
	Deferral reduced: Deferral/outbound loss (that is treated as suspended loss) rules turned off	Deferral reduced: Deferral/outbound loss (that is treated as suspended loss) rules turned off

	CRE	No CRE
No ARE	Simplified: Current average rates used for all P&L, FEED, and basis on transfers	Complex: Historic rates used for historic items in all P&L and FEED, and basis on transfers of historic items
	Increased exposure: 987 gain or loss on all items	Decreased exposure: 987 gain or loss on marked items
	No acceleration: Recognize section 987 gains and losses upon QBU remittances	No acceleration: Recognize section 987 gains and losses upon QBU remittances.
	Suspended loss rules apply to all losses	Suspended loss reduced: Suspended loss rules apply only to pre-transition and pre-ARE suspended losses
	Deferral/outbound loss (suspended loss) rules may also apply	Deferral/outbound loss (suspended loss) rules may also apply

Observations:

- Taxpayers will need to carefully model and analyze the impacts of the CRE and the ARE, given that the election or revocation of such elections generally will be binding for five taxable years.
- Taxpayers that have a Section 987 QBU that terminates prior to the taxable year in which the 2023 Proposed Regulations apply will need to consider whether to make the amortization election. However, by making the election, taxpayers likely are bound under the consistency rules to apply the election to all Section 987 QBUs with pre-transition section 987 gains and losses when the 2023 Proposed Regulations go into effect.

Partnerships

Aggregate approach for section 987 aggregate partnerships: The 2023 Proposed Regulations preserve the aggregate approach adopted in the Final Regulations for “section 987 aggregate partnerships,” which are partnerships that:

1. Have one or more QBUs, at least one of which would be a Section 987 QBU with respect to a partner if the partner owned the eligible QBU directly, and
2. Where all of the interests in partnership capital and profits are owned, directly or indirectly, by persons related to each other within the meaning of sections 267(b) or 707(b).³⁹

³⁹ (2023) Prop. Reg. §1.987-1(h).

Very generally, the aggregate approach first adopted in the Final Regulations “looks through” the partnership to treat each partner of a section 987 aggregate partnership as directly having a QBU whenever the partnership owns a QBU with a functional currency different than the functional currency of the partner. Thus, a section 987 aggregate partnership does not itself have a functional currency. Complex rules are required to coordinate the rules and principles of Subchapter K with this fully aggregate approach to QBUs held “through” section 987 aggregate partnerships.

Hybrid approach for all other partnerships: For all other partnerships (*i.e.*, partnerships *other than* section 987 aggregate partnerships), a “hybrid” aggregate/entity approach is proposed. Under this hybrid approach:

- The partnership would be treated as a QBU having its own functional currency.⁴⁰
- If the partnership owns an eligible QBU with a functional currency different from the functional currency of the partnership, the eligible QBU would be treated as a Section 987 QBU, and the partnership (and not the partner) generally would be treated as the owner of the eligible QBU.⁴¹ The partnership would determine its unrecognized section 987 gain or loss for a taxable year under (2023) Prop. Reg. §1.987-4(d) by reference to the functional currency of the partnership and the Section 987 QBU.⁴²
- The partnership then would annually allocate to each partner a share of the unrecognized section 987 gain or loss based on the partner’s distributive share of profits and losses attributable to that QBU for that year.⁴³
- At the partner level, each partner would translate its share of the unrecognized section 987 gain or loss from the partnership’s functional currency into the partner’s functional currency at the yearly average exchange rate and calculate its *net* unrecognized section 987 gain or loss with respect to each Section 987 QBU of the partnership.⁴⁴
- Section 987 gain or loss attributable to a Section 987 QBU owned by the partnership would be recognized and taken into account at the partner level, but the amount of such recognition would be determined by reference to the remittance proportion with respect to the QBU, which would be determined at the partnership level.⁴⁵
- The rules with respect to deferred section 987 gain or loss and suspended section 987 loss would be applied at the partner level.⁴⁶
- To the extent a partner recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss, the partner’s outside basis in the partnership would be adjusted as if the item of income or loss were part of the partner’s distributive share of partnership items.⁴⁷ In the case of tiered partnership structures, such outside basis adjustments would “tier down” to each intermediate

⁴⁰ Treas. Reg. §1.989(a)-1(b)(2)(i)(C); Treas. Reg. §1.985-1(a)(1).

⁴¹ (2023) Prop. Reg. §1.987-7A(b).

⁴² *Id.*

⁴³ (2023) Prop. Reg. §1.987-7A(c)(1)(i).

⁴⁴ (2023) Prop. Reg. §§1.987-7A(c)(1)(i) and (2).

⁴⁵ (2023) Prop. Reg. §§1.987-7A(c)(1)(iii) and (3).

⁴⁶ (2023) Prop. Reg. §1.987-7A(c)(4).

⁴⁷ (2023) Prop. Reg. §1.987-7A(d)(1).

partnership until it reached the lower-tier partnership to which the section 987 gain or loss was attributable.⁴⁸ Such tiered-down basis adjustments would constitute adjustments solely with respect to the partner that adjusts its basis in the upper-tier partnership.⁴⁹

Observations:

- In addition to the challenge of maintaining accurate section 987-related information in complex, multi-tiered partnership structures (including with respect to basis adjustments), the hybrid approach raises a number of difficult issues that are not addressed in the 2023 Proposed Regulations, such as the consequences upon a transfer of partnership interests.

Other notable rules relating to partnerships:

- **Generally applicable transition rules apply unless partnerships had previously adopted an aggregate approach or are section 987 aggregate partnerships:** For partnerships that own Section 987 QBUs, are not section 987 aggregate partnerships, and that had not previously adopted an aggregate approach to section 987, the general transition rules appear to apply.⁵⁰ For partnerships that must transition from an aggregate approach to the hybrid approach, or from an entity approach to the fully aggregate approach prescribed for section 987 aggregate partnerships, special transition rules apply.⁵¹
- **S corporations treated as partnerships:** Under the 2023 Proposed Regulations, S corporations would be treated for purposes of section 987 in the same manner as partnerships and shareholders of S corporations in the same manner as partners of partnerships.⁵²

Consolidated group rules

Deemed transactions between members of a consolidated group:

- To facilitate single-entity treatment, the 2023 Proposed Regulations treat a transaction between the Section 987 QBU of one member and any other member of the same consolidated group (including a Section 987 QBU of that other member) as a combination of:
 - An intercompany transaction between the members, and
 - A transfer between each Section 987 QBU and its owner (see Prop. Reg. §1.987-2(c)) as necessary to take into account the effect of the transaction on the assets and liabilities of each Section 987 QBU.
- For example, if member A makes a EUR-denominated loan to the Section 987 QBU of member B, it is treated as if member A made a EUR-denominated loan to member B, followed by a contribution of the EUR cash from the loan to its Section 987 QBU. A payment of interest or principal from the Section 987 QBU is treated as a transfer of EUR cash from the Section 987 QBU to member B, followed by a payment from member B to member A under the EUR-denominated loan.

⁴⁸ (2023) Prop. Reg. §1.987-7A(d)(2).

⁴⁹ Id.

⁵⁰ Cf. (2023) Prop. Reg. §§1.987-1(b) (stating that general rules apply to partnerships except when otherwise provided), 1.987-10(g) (providing rules for certain partnership transition situations).

⁵¹ (2023) Prop. Reg. §1.987-7C.

⁵² (2023) Prop. Reg. §1.987-7A(g).

Observations:

- It is unclear how a taxpayer would transition to this construct if the taxpayer has existing loans between a Section 987 QBU owned by one member and any other member of the same consolidated group (including a Section 987 QBU of that other member). While the 2023 Proposed Regulations potentially increase the scope of transactions involving Section 987 QBUs held by US consolidated group members, these rules may be welcomed by taxpayers that were concerned about the recognition of section 988 losses where the conditions of the matching rule of the consolidated return regulations were not met because the transactions involved a Section 987 QBU.

Suspended loss rules if a current rate election is made or if taxpayer has pre-transition section 987 loss

Suspended loss and the loss-to-the-extent-of-gain rule:

- The suspended loss rules can apply to five section 987 loss scenarios:
 - Pre-transition section 987 loss that is not subject to the amortization election;
 - Pre-transition section 987 loss that is subject to the amortization election, but is accelerated under certain section 381(a) transactions;
 - Section 987 loss realized when a CRE is in effect;
 - Section 987 loss that is treated as suspended losses in an outbound loss event; and
 - Section 987 loss of more than \$5 million incurred pre-ARE.
- The suspended loss rules now incorporate the “outbound loss event” rules that were formerly part of the Treas. Reg. §1.987-12 Final Regulations regarding deferral events.⁵³ The proposed regulations provide that outbound section 987 loss is treated as suspended section 987 loss rather than adjusting the basis of stock (or recognized when the owner of the Section 987 QBU and the related foreign person cease to be related). The preamble to the 2023 Proposed Regulations indicates that this change was intended to permit the recognition of outbound loss to the extent the owner recognizes section 987 gain in the same recognition grouping.
- **CRE in effect with no ARE:** If a CRE is in effect, the 2023 Proposed Regulations generally would suspend the recognition of section 987 loss as a result of remittance (including a deemed remittance from the termination of the QBU) until a taxable year in which an equal or greater amount of section 987 gain in the same “recognition grouping”⁵⁴ is recognized or until the occurrence of certain recognition events (the “loss-to-the-extent-of-gain rule”).⁵⁵
- The suspended loss rules apply at the owner level to the aggregate of the section 987 gains and losses.⁵⁶ All members of a consolidated group are treated as a single owner.⁵⁷

⁵³ (2023) Prop. Reg. §1.987-13(h).

⁵⁴ (2023) Prop. Reg. §1.987-11(f)(1). In general, section 987 gain and suspended section 987 loss are in the same recognition grouping if they are both initially assigned to US source income or to foreign source income in the same section 904 category.

⁵⁵ (2023) Prop. Reg. §1.987-11(c); (2023) Prop. Reg. §1.987-11(e)(1) and (f).

⁵⁶ (2023) Prop. Reg. §1.987-11(e)(1).

⁵⁷ (2023) Prop. Reg. §1.987-11(e)(3).

- **CRE and ARE both in effect:** If, in addition to a CRE, the taxpayer makes an ARE, the suspended loss rule does not apply to net unrecognized section 987 loss accrued while the election is in effect.⁵⁸ However, the application of the loss-to-the-extent-of-gain rule can still apply to suspended loss even with the ARE.
- The loss-to-the-extent-of-gain rule applies by reference to the net cumulative amount of section 987 gain in each recognition grouping that is recognized by the taxpayer during the relevant testing period⁵⁹ (rather than the gross amount recognized each taxable year).⁶⁰
- **ARE made in a taxable year after the CRE is in effect:** The suspended loss rules may apply at the time an ARE is made.
- At the beginning of the first taxable year for which the ARE is made, net unrecognized section 987 loss and deferred section 987 loss are converted into *suspended loss* if:
 - A CRE was in effect for the immediately preceding taxable year, or
 - The sum of the owner's net accumulated section 987 loss plus its deferred section 987 loss exceed by more than \$5 million the sum of the owner's net accumulated section 987 gain plus its deferred section 987 gain.
- The 2023 Proposed Regulations provide a successor rule that applies when a Section 987 QBU with suspended section 987 loss terminates. Under the successor rule, the suspended section 987 loss is not recognized in the taxable year of termination, but instead becomes attributable to a "successor suspended loss QBU." A successor suspended loss QBU may include a corporation that has no Section 987 QBUs.⁶¹
- If a Section 987 QBU (or its successor) terminates without a successor, the original owner of the Section 987 QBU recognizes all of its suspended section 987 loss with respect to the Section 987 QBU (or its successor).⁶² This generally is limited to situations where a Section 987 QBU's assets are sold to an unrelated party or the QBU ceases its business operations.
- There is a complex set of rules addressing terminations of a section 987 QBU with suspended losses and transfers of QBUs to "successor suspended loss QBUs."
 - To generalize, while most suspended losses are either recognized upon a termination or preserved in the hands of a successor suspended loss QBU, suspended section 987 loss can be lost entirely in certain circumstances.
 - For example, suspended section 987 loss is lost when the owner of a Section 987 QBU liquidates in a transaction described in section 331.
 - Also, suspended section 987 loss is eliminated in an inbound liquidation or reorganization in a section 381(a) transaction.⁶³

⁵⁸ (2023) Prop. Reg. §1.987-11(c).

⁵⁹ The period in which section 987 loss is suspended and both a CRE and an ARE are in effect. (2023) Prop. Reg. §1.987-11(e)(2)(iii).

⁶⁰ (2023) Prop. Reg. §1.987-11(e)(2).

⁶¹ (2023) Prop. Reg. §1.987-13(b)(1).

⁶² (2023) Prop. Reg. §1.987-13(b)(2) and (c)(2).

⁶³ (2023) Prop. Reg. §1.987-13(g).

Observations:

- The suspended loss rules generally suspend the section 987 loss on remittances, while the deferral event rules generally defer the section 987 loss on QBU terminations. In certain situations, a deferred section 987 loss can be converted to suspended loss.
- The suspended loss rules generally apply where the taxpayer has made a CRE.
- The suspended loss rules incorporate the “outbound loss event” rules that were formerly part of Treas. Reg. §1.987-12 in the Final Regulations regarding deferral events by treating such loss amounts as suspended loss.
- Before making a CRE, a taxpayer should carefully consider and analyze the effects of the suspended loss rules, which apply whenever a CRE is made. The suspended loss rules have a similar effect to the straddle rules in the sense that section 987 gains are taken into account upon a remittance, but losses are subject to potential suspension.
- Taxpayers should consider making the ARE at the time the CRE is made, as this will mitigate application of the suspended loss rules. The combination of the ARE and the CRE could simplify the application of the section 987 regulations where a CRE is made.
- Transfers of suspended loss QBUs raise complicated technical issues and must be analyzed carefully.

Changes to the deferral rules

Treas. Reg. §1.987-12 of the Final Regulations contains rules that defer the recognition of section 987 gain or loss in connection with two categories of related party transactions: deferral events and outbound loss events.

De minimis and other exceptions:

- One of the exceptions to these rules is a \$5 million *de minimis* exception. Under the Final Regulations, the \$5 million *de minimis* exception was applied on a QBU-by-QBU basis.⁶⁴ The 2023 Proposed Regulations provide that the \$5 million *de minimis* exception applies to the total deferred section 987 gain or loss that would otherwise be recognized by the owner in a single taxable year (*i.e.*, taking into account all QBUs of the owner).⁶⁵ Further, amounts treated as suspended loss (including amounts considered as suspended loss due to “outbound loss events”) are not taken into account in determining whether the \$5 million threshold is met.⁶⁶
- In addition to the *de minimis* aggregation rule, the 2023 Proposed Regulations provide that (2023) Prop. Reg. §1.987-12 does not apply to a termination of a Section 987 QBU in a taxable year in which an ARE is in effect.⁶⁷

Deferral event rules: Minor changes have been made to the core of the deferral event rules including coordination with the suspended loss rules. Note that section 987 loss may be suspended with respect to a deferral event if an ARE is in force.

⁶⁴ Final Treas. Reg. §1.987-12(a)(3)(ii).

⁶⁵ (2023) Prop. Reg. §1.987-12(a)(2)(ii).

⁶⁶ *Id.*

⁶⁷ (2023) Prop. Reg. §1.987-12(a)(2)(i).

Outbound loss event rules: Under the Final Regulations an outbound loss event from the transfer of QBU assets in a section 351 or 361 transaction results in non-recognition of any section 987 loss and, generally, the reflection of that loss into the basis of the stock received in the transaction. The 2023 Proposed Regulations change this rule by:

1. Removing outbound loss events from the deferral event rules of (2023) Prop. Reg. §1.987-12 (and addressing such events in (2023) Prop. Reg. §1.987-13 regarding the treatment of suspended section 987 loss upon terminations) and
2. Providing that outbound section 987 loss is treated as suspended section 987 loss, instead of being added to the basis of stock.⁶⁸

As indicated above, this rule is intended to permit the recognition of outbound section 987 loss to the extent the owner recognizes section 987 gain in the same recognition grouping, as explained in the section of this alert discussing the suspended loss rules.

Observations:

- The deferral event rules apply whether or not a CRE is in effect.
- If an ARE is in effect, the deferral event rules do not apply. Thus, an ARE mitigates the complexity of both the suspended loss rules and the deferral event rules simplifying the application of the 2023 Proposed Section 987 Regulations.
- The interaction of the suspended loss rules and the deferral event rules is challenging and requires careful analysis.

Source and character of section 987 gains and losses

- The 2023 Proposed Regulations continue to follow the principles from the Final Regulations for the determination of the source and character of section 987 gains and losses. Section 987 gains and losses are considered ordinary income.⁶⁹
 - A tax owner initially assigns section 987 gain or loss from a QBU to the statutory and residual groupings of income using the tax book value asset method of Treas. Reg. §1.861-9(g) and Treas. Reg. §1.861-9T(g). Moreover, the relevant assets for the asset method only include assets properly attributable to the QBU under the 2023 Proposed Regulations.⁷⁰
 - For purposes of the initial assignment of section 987 gain or loss, the section 987 gain or loss is assigned after any reattribution of income to the foreign branch category under Treas. Reg. §1.904-4(f)(2)(vi) and the reattribution of tested income under Treas. Reg. §1.951A-2(c)(7)(ii)(B)(2).⁷¹
 - The initial assignment rules apply for purposes of applying the “loss-to-the-extent-of-gain” rule in the suspended loss rules.⁷²
 - Section 987 gain or loss for a CFC is reassigned after the initial assignment to account for the application of the high-tax exception for passive category income, the high-tax exception

⁶⁸ (2023) Prop. Reg. §1.987-13(h).

⁶⁹ (2023) Prop. Reg. §1.987-6(b).

⁷⁰ (2023) Prop. Reg. §1.987-6(b)(2)(i)(A).

⁷¹ (2023) Prop. Reg. §1.987-6(b)(2)(i)(B).

⁷² (2023) Prop. Reg. §1.987-6(b)(2)(i)(E).

for Subpart F income, and the GILTI high-tax exclusion. Moreover, any section 987 gain or loss for the current taxable year is then reassigned to the appropriate groupings, taking into consideration whether the exclusions above apply.⁷³

- Consistent with the Final Regulations, section 987 gains or losses that are assigned to Subpart F income groups are treated as foreign currency gains and losses not directly related to the business needs of the CFC, generally resulting in passive category foreign personal holding company income currency gains and losses (*i.e.*, netting with section 988 gains and losses not meeting the business needs exception) for the CFC tax owner.⁷⁴
- A taxpayer that uses an eligible method to determine its pre-transition section 987 gains and losses must apply the sourcing and character rules of the 2023 Proposed Regulations, *even if* the eligible method employed by the taxpayer otherwise provides a sourcing and character rule.⁷⁵

Observations:

- The source and character rules are critical for the application of the suspended loss and deferral rules in the 2023 Proposed Regulations. Suspended or deferred section 987 losses are only recognized by the tax owner to the extent future section 987 gains recognized by the tax owner have the same source and character as the suspended or deferred section 987 losses.
- Moreover, taxpayers will need to carefully model and analyze the impact of making Subpart F high-tax and GILTI high-tax exclusion elections, as the elections may significantly impact the assignment of current-year section 987 losses and the utilization of prior suspended section 987 losses.
- For taxpayers that have CFCs that hold Section 987 QBUs that earn foreign base company sales income under section 954(d) or foreign base company services income under section 954(e), the 2023 Proposed Regulations may pose challenges, as there is a potential mismatch between the character of the CFC's income of the QBU (potentially general category Subpart F income) and the character of the section 987 gains and losses (passive category Subpart F income).

Section 988

In summary, there are no significant changes to the section 988 regulations since the Final Regulations. The Final Regulations provided extensive rules for section 988 transactions of Section 987 QBUs. Most of such rules were temporary, expiring in 2019 and becoming proposed regulations. The 2023 Proposed Regulations generally retain such proposed regulations. Thus:

- Whether a transaction is a section 988 transaction is determined vis-à-vis the QBU's functional currency.
- Section 988 gain or loss is determined vis-à-vis the owner's functional currency (except for certain transactions that are subject to certain mark-to-market regimes, in which case the gain or loss is determined vis-à-vis the QBU's functional currency).

⁷³ (2023) Prop. Reg. §1.987-6(b)(2)(ii).

⁷⁴ (2023) Prop. Reg. §1.987-6(b)(2)(i)(D).

⁷⁵ (2023) Prop. Reg. §1.987-10(h)(1).

- A section 988 transaction is treated as a historic item for purposes of section 987 (except certain transactions that are subject to certain mark-to-market regimes, which are treated as marked items).
- A transaction denominated in the owner's functional currency is not a section 988 transaction and is a historic item (except for certain transactions that are subject to certain mark-to-market regimes, in which case they are treated as a section 988 transaction and a marked item).
- The rules provide a mark-to-market election for Section 987 QBUs for qualified short-term section 988 transactions and cash.
- Comments were requested on treatment of section 988 gains and losses in the context of CREs and AREs, as well as potentially expanding or creating certain taxpayer-friendly rules.
- Transactions recorded on the books of a section 987 aggregate partnership or a DRE but not attributable to an eligible QBU, are treated as owned, for purposes of section 988, by the partners of the partnership or the owner of the DRE.⁷⁶
- See also the discussion of consolidated group rules and sourcing and characterization rules, which may implicate section 988.

Observations:

- The 2023 Proposed Regulations do not provide transition rules for section 988 transactions that would cease to be section 988 transactions under the new regime.
- The treatment of section 988 transactions under the 2023 Proposed Regulations continue to make it challenging for taxpayers to utilize a Section 987 QBU as a treasury center that performs cash pooling, lending, and hedging activities.

Contacts

[Michael Mou](#) (Washington, DC)

[Aziza Yuldasheva](#) (Washington, DC)

[Matthew Heeman](#) (Cincinnati)

[Ari Berk](#) (Washington, DC)

[Craig Foxgrover](#) (Chicago)

[Michael Kohler](#) (New York)



⁷⁶ Treas. Reg. §1.988-1(a)(4) (not yet effective).

30 Rockefeller Plaza
New York, NY 10112-0015
United States

This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.

As used in this document, "Deloitte" means Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2023 Deloitte Development LLC. All rights reserved.