

Code Sec. 987 Proposed Regulations—A Choose-Your-Own-Adventure Experience (with a Surprise Ending for Some QBUs)

By Brian Jenn



Enacted as part of the Tax Reform Act of 1986, applying Code Sec. 987 has increasingly become an experience akin to those young reader “choose-your-own-adventure” books, where the reader makes choices for the protagonist that may lead to fortune or ruin. Most are familiar with the basic plot of the Code Sec. 987 saga, the high points (or low points, depending on your view) of which include proposed regulations issued in 1991 and in 2006 reflecting fundamentally different paradigms, as well as final regulations that were issued in 2016 but (apart from some loss deferral and anti-abuse rules¹) have not taken effect due to a series of notices delaying the applicability date a year at a time. The lack of applicable regulations for the nearly four decades of Code Sec. 987’s existence has left taxpayers with the flexibility to choose their own reasonable approach to applying Code Sec. 987, whether based on one of the sets of proposed regulations or some variation thereon. While even some taxpayers with Code Sec. 987 qualified business units (“QBUs”) have treated Code Sec. 987 as an afterthought in terms of resource allocation, other taxpayers have developed and applied more rigorous methodologies.



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The latest entry in the Code Sec. 987 saga arrived with fanfare (from the 17 or so fans of Code Sec. 987) on November 9, 2023, in the form of yet another set of proposed regulations (the “2023 Proposed Regulations”). For better or worse, however, the 2023 Proposed Regulations represent a refinement of the paradigm of the final regulations issued in 2016 (the “2016 Final Regulations”) rather than a completely new theory of how Code Sec. 987 gain or loss should be determined and accounted for. Although the 2023 Proposed Regulations introduce much additional detailed nuance to the basic framework of the 2016 Final Regulations,³ the big story of the 2023 Proposed Regulations is a pair of key elections that continue the “choose-your-own-adventure” aspect of Code

Sec. 987, as well as a revised set of rules for transitioning from a taxpayer's current Code Sec. 987 method to the method of the 2023 Proposed Regulations.

This column will focus on those key elections and on the transition rules—which contain a surprise for QBUs that terminate before final regulations are issued—and will leave to others a detailed explication of the new proposed rules regarding partnerships and other special entities and characterization of Code Sec. 987 gain or loss (among other issues).

Obligatory Backstory

Code Sec. 987 generally provides that a taxpayer having a QBU (*e.g.*, a branch) with a different functional currency than the dollar must do several things, including (1) compute the taxable income of the QBU in the QBU's functional currency and then translate it into the owner's functional currency and (2) recognize as ordinary income Code Sec. 987 gain or loss with respect to the QBU upon remittances from the QBU.⁴ In light of the very few words Congress expended in articulating how to apply these rules, Congress also granted the Secretary of the Treasury a broad authority to prescribe regulations “as may be necessary or appropriate to carry out the purposes” of Subpart J (*i.e.*, Code Secs. 985-989).

The original Code Sec. 987 proposed regulations issued in 1991 (the “1991 Proposed Regulations”) described with admirable brevity a method for calculating Code Sec. 987 gain or loss that effectively treated all of a QBU's assets and liabilities as giving rise to foreign currency gain or loss. Under the 1991 Proposed Regulations, a taxpayer was required to maintain for each QBU an “equity pool” denominated in the functional currency of a QBU and “basis pool” in the owner's functional currency. QBU income and contributions to the QBU generally increased the pools, while QBU losses and remittances generally decreased the pools. Taxpayers recognize Code Sec. 987 gain or loss upon a remittance from the QBU based on the difference between the portion of the basis pool remitted and the portion of the equity pool (translated into the owner's functional currency) remitted. The income of the QBU is translated into the owner's functional currency under the 1991 Proposed Regulations at the yearly average exchange rate. At a high level, the 1991 Proposed Regulations determine Code Sec. 987 gain or loss on a similar manner as foreign currency translation gain and loss is determined by U.S. taxpayers for financial accounting purposes.

In contrast to the 1991 Proposed Regulations, the 2016 Final Regulations (which were based on proposed

regulations issued in 2006) determined Code Sec. 987 gain or loss in a way that treated only financial assets—and not trucks, cars, machinery, *etc.*—as giving rise to foreign currency gain or loss. To accomplish this, the 2016 Final Regulations required a comparison of adjusted QBU balance sheet values (translated into the owner's functional currency) from year end to year end. The vexing part of this exercise for some taxpayers was that the non-financial assets on the balance sheet (referred to as “historic items” or “historic assets”) had to be translated at a “historic rate,” which generally meant the average exchange rate for the year the QBU acquired the historic asset. (Financial-type assets, referred to as “marked items,” were translated at the year-end spot rate.) Even more burdensome was the fact that in order to determine the QBU's income or loss in the owner's functional currency, certain expense items (*e.g.*, depreciation and cost of goods sold (“COGS”)) had to be translated at a historic rate for the corresponding asset, as well.

The 2016 Final Regulations were issued in the waning days of the Obama Administration and came under review at the beginning of the Trump Administration pursuant to Executive Order 13789, which directed the Secretary to mitigate the burden of regulations that impose undue financial burdens or add undue complexity. In a report describing the results of that review (the “2017 Report”),⁵ Treasury identified the 2016 Final Regulations as potentially guilty on both counts and announced that it intended to issue new proposed regulations that would include elections to simplify the calculation of Code Sec. 987 gain or loss and translation of a QBU's income, as well as considering alternative transition rules. Treasury also indicated that taxpayers would be allowed to defer application of the 2016 Final Regulations and followed up on this commitment with a series of deferral notices (most recently, Notice 2022-34, allowing taxpayers to defer application of the regulations until taxable years beginning after December 7, 2023).

Choices, Choices ... New Elections with Significant Consequences

In issuing the 2023 Proposed Regulations, Treasury and the Internal Revenue Service (“IRS”) have made good on the promise they made in the 2017 Report to simplify by providing more options! In this regard, the key elections are the Current Rate Election⁶ and the Annual Recognition Election, each of which brings some simplification (relative to the 2016 Final Regulations) but also has consequences for the overall amount, and timing of recognition, of Code Sec. 987 gain or loss.

Current Rate Election

Under the Current Rate Election, a taxpayer would treat all of the items properly reflected on a QBU's books and records as marked items. The upshot of this is that unlike under the 2016 Final Regulations, a taxpayer would never need to keep track or use historic rates (or dates assets were acquired by a QBU). Rather, to determine Code Sec. 987 gain or loss, the QBU's year-end balance sheet—historic items and all—would be translated at the year-end spot rate. Similarly, all of the revenue expense items that make up a QBU's income or loss would be translated at the yearly average exchange rate.

A consequence of determining Code Sec. 987 gain or loss by translating year-end balance sheets entirely at the year-end spot rate is that all items on the balance sheet—not just marked items—contribute to the calculation of Code Sec. 987 gain or loss, as under the 1991 Proposed Regulations. (Translating historic items at the same historic rate each year under the 2016 Final Regulations effectively removed historic items from the Code Sec. 987 gain or loss calculation.) Consequently, the magnitude of Code Sec. 987 gain or loss could be much larger under the 2023 Proposed Regulations than it would be under the 2016 Final Regulations, particularly for a QBU with a significant amount of historic assets.

Because the Current Rate Election can produce large amounts of Code Sec. 987 gain or loss related to assets that arguably do not fluctuate in value based on exchange rates, a consequence of the Current Rate Election is that taxpayers making the election can only take into account recognized Code Sec. 987 loss to the extent of Code Sec. 987 gain—if *any*—recognized by the same Code Sec. 987 QBU owner (with respect to the same or a different QBU) in the same year or a future year.⁷ This “loss-to-the-extent-of-gain” rule means that taxpayers generally will never recognize annual Code Sec. 987 losses and instead will only recognize Code Sec. 987 gains (reduced by losses). The rules governing the circumstances under which losses suspended under the loss-to-the-extent-of-gain rule can be recognized are complex and beyond the scope of this column.

Annual Recognition Election

Under the Annual Recognition Election, a taxpayer recognizes all of the Code Sec. 987 gain or loss with respect to a Code Sec. 987 QBU on an annual basis.⁸ Although this election could introduce some volatility into the tax provision, it comes with some benefits. First, the Annual Recognition Election allows for the recognition of annual net Code Sec. 987 losses, even if the Current Rate Election is made and the loss-to-the-extent-of-gain rule otherwise would apply.

Second, even if the Current Rate Election is not made, a taxpayer making the Annual Recognition Election may translate the QBU's income entirely at the yearly average exchange rate rather than using historic rates for depreciation.⁹ Making the Annual Recognition Election without making the Current Rate Election also has the benefit that smaller amounts of Code Sec. 987 gain generally will be recognized than if the Current Rate Election is in effect.

Election Consistency and Timing Considerations

The 2023 Proposed Regulations include new rules regarding elections, including a consistency requirement and special rules for the timing of the Current Rate Election and the Annual Recognition Election. For all elections under Code Sec. 987, the new consistency requirement would provide that all consolidated group members that own a QBU would be required to make consistent elections for their own QBUs and for QBUs of controlled foreign corporations (“CFCs”) of which they are U.S. shareholders owning more than 50% of the CFC stock directly or indirectly.¹⁰

In addition to the consistency requirements, the Current Rate Election and the Annual Recognition Election would be subject to new timing requirements. These elections could be made or revoked without the consent of the Commissioner but, once made, could not be revoked (or made again, if previously revoked) until 60 months had passed since the first day of the first taxable year for which the election was effective.¹¹

A Happy Ending for Prior Code Sec. 987 Methods? Beware Pre-Transition QBU Terminations

The 2023 Proposed Regulations include new rules for transitioning from a prior Code Sec. 987 method and—keeping with the choose-your-own-adventure theme—once again offer an election. Taxpayers should beware, however, that under a special effective date in the 2023 Proposed Regulations, the Code Sec. 987 consequences for a QBU terminating on or after November 9, 2023 would be subject to the rules in the 2023 Proposed Regulations when those rules are finalized.¹²

Treatment of Pre-Transition Code Sec. 987 Gain or Loss

Under the 2023 Proposed Regulations, Code Sec. 987 gain or loss with respect to a QBU for pre-transition

years must be accounted for upon the transition to new final regulations and cannot simply be ignored. Pre-transition unrecognized Code Sec. 987 gain with respect to a QBU is generally carried over to the post-transition QBU as net accumulated Code Sec. 987 gain that can be recognized upon a remittance or termination.¹³ Pre-transition unrecognized Code Sec. 987 loss, on the other hand, becomes suspended Code Sec. 987 loss that generally can be recognized only to the extent of Code Sec. 987 gains that are recognized by the same QBU owner.¹⁴

Although the general transition rule is that pre-transition Code Sec. 987 gains become net accumulated unrecognized Code Sec. 987 gain and Code Sec. 987 losses are suspended, the 2023 Proposed Regulations provide a special election to recognize pre-transition Code Sec. 987 gain or loss over a 10-year period.¹⁵ This election is generally the only way for a taxpayer to recognize an unrecognized Code Sec. 987 loss with respect to a transitioning QBU and is subject to the consistency requirements described above—*i.e.*, that the same election applies to all QBUs held by a U.S. consolidated group and all QBUs held by CFCs in which it is a majority shareholder. Consequently, it is not possible to selectively choose to selectively recognize pretransition losses and not pretransition gains.

Determining the Amount of Pre-Transition Code Sec. 987 Gain or Loss

Pre-transition Code Sec. 987 gain or loss with respect to a transitioning Code Sec. 987 QBU must be taken into account as just described, but how is the amount of Code Sec. 987 gain or loss determined? The answer will depend on whether the QBU's owner applied an "eligible pretransition method." In general, taxpayers that applied an eligible pretransition method can carry over the unrecognized Code Sec. 987 gain or loss determined with respect to a QBU under their prior Code Sec. 987 method, subject to an adjustment to account for the fact that the QBU's assets are translated at the transition date spot rate for purposes of determining Code Sec. 987 gain or loss going forward.¹⁶ Taxpayers that did not apply an eligible pretransition method are required to undertake a more burdensome process that requires QBU's historic balance sheets for its *entire* history of ownership of the QBU, as well as the Code Sec. 987 gain or loss recognized with respect to the QBU over the same period. Doing so is likely to present major challenges to taxpayers that may not have access to records with respect to a QBU potentially over a decades-long history—or in a case in which the QBU owner was acquired in a third-party acquisition.

An eligible pretransition method generally includes a method of applying Code Sec. 987 that requires Code Sec. 987 gain or loss to be determined and recognized with respect to both earnings and capital of the QBU, as under the 1991 Proposed Regulations.¹⁷ An "earnings only" version of the 1991 Proposed Regulations also qualifies as an eligible pretransition method, provided the method was first applied on a return filed before November 9, 2023. Importantly, however, a Code Sec. 987 method is *not* an eligible pretransition method unless the owner of the Code Sec. 987 QBU recognizes Code Sec. 987 gain or loss upon a transfer of property from the Code Sec. 987 QBU to the owner.¹⁸ This limitation may raise questions for taxpayers that have recognized Code Sec. 987 gain or loss upon distributions from the QBU but not with respect to other property transfers, such as upstream loans or payments of interest, royalties, or service fees.

Special Rule for QBUs Terminating on or After November 9, 2023

As noted above, a special transition rule and applicability date would apply to a QBU terminating on or after December 9, 2023, assuming the 2023 Proposed Regulations are finalized as proposed. Under these special rules, the terminating QBU would be subject to the transition rules in the 2023 Proposed Regulations, with several important consequences. In general, unrecognized "pre-transition" gain with respect to the QBU would be determined under the rules described above and recognized upon termination. Consequently, for QBU owners that were not following an eligible pretransition method with respect to the QBU, the amount of gain recognized on the termination could be different than otherwise would have been the case. Additionally, any unrecognized pre-transition Code Sec. 987 loss could become suspended Code Sec. 987 loss that may not be able to be recognized unless the owner of the terminating Code Sec. 987 QBU has another Code Sec. 987 QBU that recognizes Code Sec. 987 gain, allowing the suspended Code Sec. 987 loss to be recognized in part or whole under the loss-to-the-extent-of-gain rule. The fact that the consequences of terminating a QBU today are uncertain—and depend on whether final regulations are issued and follow the 2023 Proposed Regulations—raises questions about how companies should account for the termination in their tax provision.

Getting Ready for the Adventure

The IRS and Treasury are committed to finalizing the 2023 Proposed Regulations in time for final Code Sec. 987 regulations to apply to the 2025 tax year for calendar year taxpayers. Given the past history of regulatory efforts under Code Sec. 987, readers may have doubts about the likelihood of final Code Sec. 987 regulations applying in 2025, but the possibility should not be completely discounted. Although most taxpayers likely would prefer to continue applying Code Sec. 987 as they have been doing historically, the

preamble indicates that the IRS and Treasury believe they have addressed—mainly through elections—the major concerns raised with respect to the 2016 Final Regulations, such that they may not foresee comments on the 2023 Proposed Regulations that would warrant a major shift in approach that could delay implementation.

Given the possibility of final Code Sec. 987 regulations applying in 2025, taxpayers would do well to begin considering which configuration of elections would best suit their circumstances and what resources would need to be devoted to compliance under their “customized” approach to Code Sec. 987.

ENDNOTES

¹ Reg. §1.987-12.

² REG-208270-86 (September 7, 2006).

³ Clearly, the drafters of the 2016 Final Regulations (including this author) ran out of time, steam, and/or creativity before issuing those regulations, after which a fresh team of foreign currency whizzes in the Internal Revenue Service (the “IRS”) and the Treasury Department (“Treasury”) carried on the development of the framework of the final regulations with new vigor.

⁴ Code Sec. 987(3) is not nearly this explicit about recognition of Code Sec. 987 gain or loss upon a remittance but, with help from

legislative history, has been interpreted in this way.

⁵ Second Report to the President on Identifying and Reducing Tax Regulatory Burdens (82 FR 48013, October 16, 2017).

⁶ Proposed Reg. §1.987-1(d)(2).

⁷ Proposed Reg. §1.987-11(c).

⁸ Proposed Reg. §1.987-5(b)(2).

⁹ Proposed Reg. §1.987-3(c)(2). Historic assets on the balance sheet would still need to be translated at the historic rate for calculating Code Sec. 987 gain or loss, but for this purpose, only post-transition historic rates would need to be tracked since all

assets are marked to the spot rate upon transition. Proposed Reg. §1.987-10(d)(1).

¹⁰ Proposed Reg. §1.987-1(g)(2)(ii).

¹¹ Proposed Reg. §1.987-1(g)(3)(ii)(B).

¹² Proposed Reg. §§1.987-14(a)(2), -10(c)(2), and -1(h).

¹³ Proposed Reg. §1.987-10(e)(5)(i)(A).

¹⁴ Proposed Reg. §1.987-10(e)(5)(i)(B).

¹⁵ Proposed Reg. §1.987-10(e)(5)(ii).

¹⁶ Proposed Reg. §1.987-10(e)(2).

¹⁷ Proposed Reg. §1.987-10(e)(4).

¹⁸ Proposed Reg. §1.987-10(e)(4)(iv).

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