INTERNAL REVENUE
BULLETIN

Bulletin No. 2017–2
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

REG–128276–12, page 369.

The temporary and proposed regulations contain rules relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a QBU in connection with certain QBU terminations and certain other transactions involving partnerships. The temporary and proposed regulations also provide for (i) an annual deemed termination election for a section 987 QBU; (ii) an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; (iii) rules regarding the treatment of section 988 transactions of a section 987 QBU; (iv) rules regarding QBUs with the U.S. dollar as their functional currency; (v) rules regarding combinations and separations of section 987 QBUs; (vi) rules regarding the translation of income used to pay creditable foreign income taxes; (vii) rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987; and (viii) rules under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans.

Rev. Rul. 2017–02, page 364.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, 7872, and other sections of the Code, tables set forth the rates for January 2017.

Notice 2017–03, page 368.

This notice provides the maximum vehicle values for use with the special valuation rules under regulation section 1.61–21(d) and (e) for 2017. These values are adjusted for inflation and must be adjusted annually by reference to the Consumer Price Index.

T.D. 9794, page 273.

The final regulations provide guidance under section 987 regarding the determination of the taxable income or loss of a taxpayer with respect to a qualified business unit (QBU) subject to section 987, as well as the timing, amount, character, and source of any section 987 gain or loss.

T.D. 9795, page 326.

The temporary and proposed regulations contain rules relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a QBU in connection with certain QBU terminations and certain other transactions involving partnerships. The temporary and proposed regulations also provide for an annual deemed termination election for a section 987 QBU; an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; rules regarding the treatment of section 988 transactions of a section 987 QBU; rules regarding QBUs with the U.S. dollar as their functional currency; rules regarding combinations and separations of section 987 QBUs; rules regarding the translation of income used to pay creditable foreign income taxes; rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987; and rules under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans.

T.D. 9801, page 355.

The final regulations provide a revised definition of issue price for purposes of the arbitrage restrictions under section 148 that apply to tax-exempt bonds under section 103, tax credit bonds under section 54A, and direct pay bonds under section 6431.

(Continued on the next page)

Finding Lists begin on page ii.

EMPLOYEE PLANS

Notice 2017–01, page 367.

This notice provides guidance on section 7528(b)(2) of the Code, relating to an exemption from the requirement to pay a user fee for certain requests to the IRS for determination letters with respect to the qualified status of pension, profit-sharing, stock bonus, annuity, and employee stock ownership plans maintained by small employers. This notice is being issued as a result of changes made to the determination letter program and remedial amendment period rules set forth in Rev. Proc. 2016–37, 2016–29 I.R.B. 136.

EXCISE TAX

REG–134438–15, page 373.

These proposed regulations would modify the current definition of "net premiums written" for purposes of the fee imposed by section 9010 of the Affordable Care Act.

ADMINISTRATIVE

REG–133353–16, page 372.

This document contains proposed regulations that authorize the disclosure of certain items of return information to the Bureau of the Census in conformance with section 6103(j)(1) of the Internal Revenue Code.

Notice 2017–03, page 368.

This notice provides the maximum vehicle values for use with the special valuation rules under regulation section 1.61–21(d) and (e) for 2017. These values are adjusted for inflation and must be adjusted annually by reference to the Consumer Price Index.

T.D. 9802, page 361.

This document contains temporary regulations that authorize the disclosure of certain items of return information to the Bureau of the Census in conformance with section 6103(j)(1) of the Internal Revenue Code.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

T.D. 9794

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Income and Currency Gain or Loss with Respect to a Section 987 QBU

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations that provide guidance under section 987 of the Internal Revenue Code (Code) regarding the determination of the taxable income or loss of a taxpayer with respect to a qualified business unit (QBU) subject to section 987, as well as the timing, amount, character, and source of any section 987 gain or loss. Taxpayers affected by these regulations are corporations and individuals that own QBUs subject to section 987. In addition, published elsewhere in this issue of the **Bulletin,** temporary and proposed regulations (the temporary regulations) are being issued under section 987 to address aspects of the application of section 987 not addressed in these final regulations.

DATES: *Effective date*: These regulations are effective on December 7, 2016.
Applicability dates: For dates of applicability, see § 1.987–11.

FOR FURTHER INFORMATION CONTACT: Sheila Ramaswamy at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2265. Responses to this collection of information are mandatory.

The collection of information in these final regulations is in §§ 1.987–1(b)(2)(ii), 1.987–1(c)(1)(ii), 1.987–1(c)(1)(iii), 1.987–1(g)(3)(i)(A), 1.987–1(g)(3)(i)(B), 1.987–1(g)(3)(i)(C), 1.987–1(g)(3)(i)(D), 1.987–3(c)(2)(iv)(B), 1.987–9, and 1.987–10(e). This collection of information is required to establish the taxable income or loss of a taxpayer with respect to a QBU subject to section 987, as well as the timing, amount, character, and source of any section 987 gain or loss and the exchange rates used for foreign currency translation purposes.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations relating to the determination of the taxable income or loss of a taxpayer with respect to a QBU subject to section 987 of the Code, as well as the timing, amount, character, and source of any section 987 gain or loss. The final regulations also amend existing regulations under sections 861, 985, 988, and 989.

On September 6, 2006, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–208270–86, 71 FR 52876) that proposed new regulations under section 987 (the 2006 proposed regulations) and withdrew proposed regulations under section 987 published on September 25, 1991 (INTL–965–86, 56 FR 48457) (the 1991 proposed regulations). The Treasury Department and the IRS received many written comments in response to the 2006 proposed regulations. After consideration of all the comments, the 2006 proposed regulations, as revised by this Treasury decision, are adopted as final regulations. Temporary regulations (***TD 9795***) and proposed regulations (REG–128276–12) under section 987 are being published contemporaneously with these final regulations.

Summary of Comments and Explanation of Revisions

I. *Background*

Section 987 generally provides that, when a taxpayer owns one or more QBUs with a functional currency other than the U.S. dollar and such functional currency is different than that of the taxpayer, the taxable income or loss of the taxpayer with respect to each QBU is determined by computing the taxable income or loss of each QBU separately in its functional currency and translating such income or loss at the appropriate exchange rate. Section 987 further requires the taxpayer to make "proper adjustments" (as prescribed by the Secretary) for transfers of property between QBUs having different functional currencies, including by treating post-1986 remittances from each such QBU as made on a pro rata basis out of post-1986 accumulated earnings and by treating section 987 gain or loss as ordinary income or loss and sourcing such gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.[1] Section 989(b)(4) provides that, "[e]xcept as provided in regulations," the appropriate exchange rate with respect to a QBU means "the average exchange rate for the taxable year" of the QBU. Additionally, section 989(c)(5) directs the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of [subpart J], including regulations . . . providing for the appropriate treatment of related party transactions (including transactions be-

[1]The legislative history of section 987 is discussed extensively in the preamble to the 2006 proposed regulations. *See* 71 FR 52876.

tween qualified business units of the same taxpayer) . . . .”

A. *1991 proposed regulations*

The 1991 proposed regulations generally provided that the net income of a QBU with a functional currency other than that of the taxpayer was determined annually. Such determination was based on the profit and loss appearing on the QBU’s books and records, adjusted to conform to U.S. tax principles, and translated into the functional currency of the taxpayer using the weighted average exchange rate for the taxable year. The 1991 proposed regulations also provided for the recognition of exchange gain or loss upon a remittance from the QBU’s equity pool. In general, the equity pool consisted of the contributed capital and earnings of the QBU, reduced by remittances, determined in the QBU’s functional currency. The 1991 proposed regulations also provided for a basis pool, which consisted of the basis of the capital and earnings in the equity pool, expressed in the functional currency of the taxpayer. The portion of the basis pool that was attributable to a remittance generally was determined according to the following formula:

$$\frac{\text{Amount remitted in the QBU's functional currency}}{\text{Equity pool in the QBU's functional currency}} \times \text{Basis pool in the taxpayer's functional currency}$$

Under the 1991 proposed regulations, section 987 gain or loss was the difference between the value of the remittance from the QBU, translated into the taxpayer’s functional currency at the spot rate on the date of the remittance, and the basis associated with the remittance.

One important consequence of the equity pool paradigm was that all branch equity gave rise to exchange gain or loss, regardless of whether the equity was invested in assets that actually exposed the QBU’s owner to currency fluctuations. For example, both cash denominated in the QBU’s functional currency and mobile equipment equally gave rise to exchange gain or loss. As a result, under the 1991 proposed regulations, exchange rate changes that, at most, had only an uncertain and remote effect on the economic results experienced by the owner of a QBU gave rise to substantial exchange gains and losses that taxpayers selectively could recognize by strategically timing remittances or causing a termination of the QBU. Given these distortions, the Treasury Department and the IRS withdrew the 1991 proposed regulations and proposed new regulations on September 6, 2006.

B. *2006 proposed regulations*

The 2006 proposed regulations adopted a different paradigm referred to as the foreign exchange exposure pool (FEEP) method. In general, the FEEP method provides that, as under the 1991 proposed regulations, the income of a QBU that is subject to section 987 (a section 987 QBU) is determined by reference to the items of income, gain, deduction, and loss booked to the section 987 QBU in its functional currency, adjusted to reflect U.S. tax principles. Items of income and deduction generally are translated, consistent with the 1991 proposed regulations, into the functional currency of the section 987 QBU’s owner at the average exchange rate for the year. However, the basis of certain “historic assets” and the deductions for depreciation, depletion, and amortization of such assets are translated at the historic rates for such assets. Translating these items at historic rates represents a major difference from the 1991 proposed regulations and prevents the imputation of foreign currency gains or losses to such assets. Additionally, the 2006 proposed regulations required the adjusted basis and amount realized with respect to marked assets to be translated using a spot rate, which for assets acquired in a prior taxable year would be the spot rate for the closing balance sheet of the prior taxable year.

Consistent with the 1991 proposed regulations, the FEEP method uses a balance sheet approach to determine exchange gain or loss, which is not recognized until the section 987 QBU makes a remittance. Under the FEEP method, exchange gain or loss with respect to “marked items” is determined annually but is pooled and deferred until a remittance is made. A marked item generally is defined under the 2006 proposed regulations as an asset (marked asset) or liability (marked liability) that would generate section 988 gain or loss if such asset or liability were held or entered into directly by the owner of the section 987 QBU. The balance sheet approach, together with the use of historic rates for historic items (generally defined as an asset or liability that is not a marked item), allows 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.

The 2006 proposed regulations define a remittance as a net transfer of amounts from a section 987 QBU to its owner during a taxable year, determined in the owner’s functional currency. When a section 987 QBU makes a remittance, a portion of the pooled exchange gain or loss is recognized. In general, the amount taken into account equals the section 987 QBU’s net unrecognized exchange gain or loss multiplied by the owner’s remittance proportion. The owner’s remittance proportion generally equals the amount of the remittance divided by the aggregate basis of the section 987 QBU’s gross assets reflected on its year-end balance sheet, determined in the owner’s functional currency, without reduction for the remittance.

II. *Summary of Comments and Changes*

Many comments were received in response to the 2006 proposed regulations. This Part II discusses those comments and the changes made in response to them.

Certain comments received in response to the 2006 proposed regulations are addressed in the temporary regulations and are discussed in the preamble to the temporary regulations rather than in this preamble.

A. *General comments regarding the FEEP method, including regarding administrability*

A number of comments suggested that the FEEP method, in particular §§ 1.987–3 and –4 of the 2006 proposed regulations, would be difficult to administer. Some of those comments expressed a preference to more closely align regulations under section 987 with the financial accounting rules under Accounting Standards Codification, Foreign Currency Matters, section 830 (ASC 830).[2]

ASC 830 adopts a functional currency paradigm in which assets, liabilities, and operations of a foreign entity are measured using the entity's functional currency[3] and then translated into the reporting currency (generally, the U.S. dollar) of a U.S. enterprise using a current exchange rate.[4] Thus, revenues, expenses, gains, and losses of the foreign entity, translated into U.S. dollars using a weighted average exchange rate for the reporting period, are included in the consolidated profit and loss statement of the U.S. enterprise,[5] and the assets and liabilities of the foreign entity, translated into U.S. dollars using the spot rate on the balance sheet date, are included in the consolidated balance sheet of the U.S. enterprise.[6] Foreign currency "translation" gain or loss of a foreign entity with a functional currency other than the U.S. dollar is determined with respect to all assets and liabilities on the entity's balance sheet at the end of a reporting period and reported in the cumulative translation adjustment (CTA) account. The CTA account is a sub-account in the equity section of the balance sheet.[7] It is not reflected in profit or loss until the occurrence of a sale or a complete or substantially complete liquidation of the entity.[8] ASC 830[9] explains the rationale for accounting for translation gain or loss in equity and not income:

> Translation adjustments are solely a result of the translation process and have no direct effect on reporting currency cash flows. Exchange rate changes have an indirect effect on the net investment that may be realized upon sale or liquidation, but that effect is related to the net investment and not to the operations of the investee. Prior to sale or liquidation, that effect is so uncertain and remote as to require that translation adjustments arising currently should not be reported as part of operating results.

The treatment of translation gains and losses can be contrasted with the financial accounting treatment of transactions denominated in a currency other than the entity's functional currency. Changes in exchange rates between the functional currency of the foreign entity and the currency in which such transactions are denominated give rise to changes in expected cash flows in the functional currency, resulting in "transaction" gains or losses. The financial accounting rules require the inclusion of transaction gains and losses in net income for the period in which the exchange rate changes occur.[10] The category of foreign currency transactions that give rise to transaction gains and losses under generally accepted accounting principles overlaps considerably with the definition of a section 988 transaction for tax purposes.

Some comments suggested that, in enacting section 987, Congress intended to substantially adopt the financial accounting rules for foreign currency translation for tax purposes. The Treasury Department and the IRS do not find support for this position in the legislative history to section 987 and, to the contrary, find the position belied by the significant discontinuities between section 987 and the financial accounting rules, particularly regarding the recognition of foreign currency gains and losses. Under Financial Accounting Standard No. 52 (FAS 52), translation gain or loss is deferred in an equity account until a sale or liquidation of the foreign entity, at which point the economic effects of the aggregate translation gain or loss can be measured against a real economic event. The "equity pool" paradigm of the 1991 proposed regulations determined the amount of section 987 gain or loss in a manner that was similar to the determination of translation gain or loss under FAS 52 by imputing foreign currency gain or loss to all assets and liabilities on the balance sheet. In contrast with the accounting rules under FAS 52, however, the translation gain or loss was not sequestered in an equity account but rather was included in income upon a remittance as required by the section 987 statute, making the consequences of imputing foreign currency gain or loss to all assets and liabilities substantially greater.

As expressed in the preamble to the 2006 proposed regulations, the administrative convenience achieved by generally adopting the FAS 52 computational methodology in the 1991 proposed regulations gave rise to many cases in which the section 987 gain or loss taken into account on a remittance deviated substantially from the economic results experienced by the QBU. For example, currency loss was imputed with respect to assets (such as a commercial building or an oil rig) for which, due to the mobility of investment capital or the assets themselves, exchange

[2]ASC 830 codifies Financial Accounting Standard No. 52.

[3]The functional currency of a foreign entity is defined in ASC 830 as the currency of the primary economic environment in which the entity operates.

[4]ASC 830–30–45–3.

[5]ASC 830–10–55–10–11,830–30–45–3.

[6]ASC 830–30–45–3.

[7]ASC 830–30–45–12.

[8]ASC 830–30–40–1.

[9]ASC 830–230–45–1.

[10]ASC 830–20–35–1.

rate fluctuations would have, at most, only a remote and uncertain effect on asset value. Moreover, because remittances could be funded from other assets, such loss could be recognized without regard to any realization event with respect to the assets that gave rise to the speculative or noneconomic section 987 loss.

Given the inappropriate economic and timing results attributable to adopting the FAS 52 translation methodology in the 1991 proposed regulations and the significant differences between the purposes of the FAS 52 computation of CTA and the computation of unrecognized section 987 gain or loss, the Treasury Department and the IRS remain of the view that the FAS 52 model is not appropriate for tax purposes. Similarly, the Treasury Department and the IRS have determined that an approach based on consistency with FAS 52 computations modified to address abuses, as suggested in some comments, is inappropriate because such a system would impute foreign currency gain or loss to all assets and liabilities on the balance sheet and generally allow for the recognition of such gains and losses based on remittances without regard to the owner's actual economic exposure to the QBU's functional currency. Rather, the Treasury Department and the IRS have determined that an approach premised on consistency with section 988, modified to take into account administrability and policy considerations unique to section 987, will carry out the purposes of section 987 most appropriately.

Other comments recommended a hybrid approach that would combine the methodology of the 1991 proposed regulations for computing a section 987 QBU's net income with the methodology of the 2006 proposed regulations for computing section 987 gain or loss. Under the proposed hybrid approach, section 987 gain or loss generally would be determined under the method of the 2006 proposed regulations, but taxable income or loss would be translated into the owner's functional currency at the yearly average exchange rate without any adjustments. A consequence of this hybrid approach is that a different exchange rate would be used to translate recovered basis with respect to historic assets in determining taxable income or loss than would be used to translate such basis to determine section 987 gain or loss. These comments generally favored the FEEP method for determining section 987 gain or loss because it avoids imputing section 987 gain or loss to all assets and liabilities on the balance sheet, as under the 1991 proposed regulations, but asserted that determining taxable income or loss in the functional currency of the section 987 QBU and translating that amount into the owner's functional currency at the yearly average exchange rate without any adjustments is more administrable and more consistent with sections 987(1) and (2) and the legislative history of section 987.

The Treasury Department and the IRS have concluded that the proposed hybrid approach would not achieve the goal of ensuring remittances trigger only "exchange gain or loss inherent in accumulated earnings or branch capital," as contemplated by Congress, and inappropriately would cause offsetting exchange rate effects to be reflected in section 987 taxable income or loss and in the FEEP. (H.R. Conf. Rep. No. 99–841, at 675 (1986)). Although a hybrid approach would simplify the calculation of section 987 taxable income or loss, the simplification would cause basis recovery deductions with respect to depreciable and amortizable assets that are included in section 987 taxable income or loss to reflect exchange rate fluctuations with respect to the asset (for which exchange rate fluctuations may have, at most, only a remote and uncertain effect on value). If the asset is retained on the closing balance sheet, the FEEP would reflect equal and offsetting exchange rate fluctuations with respect to the asset, to the extent of any accumulated depreciation or amortization that was included in taxable income and translated at current exchange rates. This is because, in determining section 987 gain or loss under § 1.987–4 of the 2006 proposed regulations, section 987 taxable income or loss is subtracted from the change in the owner functional currency net value (OFCNV) of the section 987 QBU, which is determined using historic exchange rates for historic items. Accordingly, the distortion in the determination of section 987 taxable income or loss with respect to historic assets would cause an offsetting distortion in the FEEP.

An example illustrates the equal and offsetting exchange rate effects that can arise with respect to a historic asset under the hybrid approach. Consider the situation of a section 987 QBU (euro QBU) that has the euro as its functional currency and that has an owner that has the dollar as its functional currency. If euro QBU acquires depreciable equipment for €100 on the last day of year 1, when the historic exchange rate is €1 = $1, and takes into account €10 of depreciation with respect to the equipment in year 2, when the yearly average exchange rate is €1 = $1.50, the €10 of depreciation would be translated at the year 2 average exchange rate into $15 under the hybrid approach rather than $10, as would happen if depreciation were translated at the €1 = $1 historic rate under the 2006 proposed regulations. As a result, section 987 taxable income of euro QBU is $5 lower under the hybrid approach than it would be under the 2006 proposed regulations.

In this example, the FEEP, in turn, would be higher by $5 under the hybrid approach than it would be under the 2006 proposed regulations. This is because, in determining the change to the FEEP for a taxable year, section 987 taxable income is subtracted from the change in OFCNV of euro QBU, which is computed by translating the adjusted basis of historic assets using the historic exchange rate for each asset. For euro QBU, solely with reference to the depreciable equipment, year 2 depreciation causes a $10 reduction in OFCNV, because in computing the change in OFCNV, the €10 change in equipment basis during year 2 is translated at the €1 = $1 historic rate (year 2 closing balance sheet of $90 adjusted basis, less year 1 closing balance sheet of $100 adjusted basis). In order to compute the change to the FEEP for year 2 with respect to the depreciable equipment, section 987 taxable income with respect to the equipment is subtracted from the $10 reduction in OFCNV. Thus, the net effect of the depreciation in the FEEP is to increase section 987 gain reflected in the FEEP by $5 (negative $10 change in OFCNV, less $15 depreciation deduction).

Considering all of these effects together, under the hybrid approach, the appreciation of the euro decreases section 987 taxable income by $5 and increases section 987 gain reflected in the FEEP by $5. In other words, the FEEP reflects currency gain or loss with respect to the depreciable asset that is offset by an amount that was included in section 987 taxable income. This effect on the FEEP persists even after the asset is sold.

The Treasury Department and the IRS have determined that the offsetting effects in section 987 taxable income or loss and in the FEEP under the hybrid approach raise concerns similar to the concerns that Congress addressed, albeit in a different context, in enacting section 1092. In particular, section 1092 reflects a policy concern regarding inconsistent timing of recognition of gains and losses from offsetting positions. Under the hybrid approach, the exchange rate effect with respect to historic assets would be reflected in section 987 taxable income or loss to the extent of any cost recovery deductions with respect to those assets, but equal and offsetting amounts would be reflected in the FEEP and would not be recognized until there are remittances. Thus, offsetting effects arising from a single asset would be taken into account at different times. Accordingly, the Treasury Department and the IRS have determined that it would be inappropriate for regulations under section 987 to permit distortions to section 987 taxable income or loss, for the sake of enhancing administrability, that have the effect of causing offsetting amounts of gain or loss to be reflected in the FEEP with respect to the same asset, where the latter amounts would be recognized only upon voluntary remittances from the QBU. Rather, consistent with the discussion in the preamble to the 2006 proposed regulations, the Treasury Department and the IRS have determined that, in order to carry out the purposes of section 987(3) as indicated by the legislative history, as well as sections 987(1) and (2), and taking into account the authority granted in sections 989(b) and (c), it is appropriate to account for recovered basis for historic assets at the relevant historic rate in determining taxable income or loss of a section 987 QBU. This result could be accomplished by translating recovered basis at the historic rate in the first instance or by translating taxable income or loss determined in the section 987 QBU's functional currency at the yearly average exchange rate and adjusting that amount to properly account for recovered basis, as under the simplified inventory method described in Part II.A.3 of this preamble.

Nonetheless, the Treasury Department and the IRS acknowledge the observations about the complexity and administrability of the 2006 proposed regulations that underlie the recommendation of the hybrid approach. The concerns about offsetting amounts recognized at different times under the hybrid approach would not arise for taxpayers that make the deemed annual termination election set forth in § 1.987–8T(d) of the temporary regulations. Accordingly, as described in the preamble to the temporary regulations, a taxpayer that makes the deemed annual termination election may also elect under § 1.987–3T(d) to apply the hybrid approach. Additionally, the Treasury Department and the IRS have made several changes in these final regulations in response to comments expressing concern about the complexity and administrability of the 2006 proposed regulations.

In addition to the comments recommending a hybrid approach under which taxable income would be translated at a single exchange rate without any adjustments, other comments expressed more particular concerns regarding the complexity and administrability of the FEEP paradigm specifically with respect to inventory and certain other high-volume, low-value assets. Comments suggested that treating items that turn over quickly, such as inventory, or that have low value as marked items would facilitate administration and compliance while introducing little distortion into the FEEP calculation. The Treasury Department and the IRS do not agree with these specific recommendations to expand the scope of marked assets, because even assets that turn over quickly or have low-value individually could inappropriately give rise to significant amounts of section 987 gain or loss in the aggregate over time. The Treasury Department and the IRS do, however, acknowledge the general points about complexity and administrability reflected in these suggestions, which are similar to the concerns expressed in the comments recommending the hybrid approach.

In order to reduce complexity and improve administrability, the final regulations modify the 2006 proposed regulations in several significant ways, including by permitting more items to be treated as section 987 marked items, simplifying the treatment of marked items so that net income attributable to such items is translated at the average exchange rate, and simplifying the adjustments that are required to translate basis recovery for historic items at the historic rate. These changes balance the administrability benefits of simplifying the final regulations and bringing them into closer conformity with financial accounting rules against the need to minimize the distortions that would result from permitting taxpayers to include uncertain and remote foreign currency gains and losses in taxable income. In particular, the final regulations allow taxpayers to (a) use the yearly average exchange rate as the historic rate, (b) treat prepaid expenses and liabilities for advance payments of unearned income as section 987 marked items, (c) apply a simplified method with respect to inventory, and (d) translate both basis recovery and amount realized with respect to marked assets at the yearly average exchange rate. Additionally, as described in the preamble to the temporary regulations, the temporary regulations treat certain section 988 transactions as marked items and permit taxpayers to elect to more closely conform the treatment of certain section 988 transactions entered into by a section 987 QBU with their treatment for financial accounting purposes.

1. Yearly Average Exchange Rate as the Historic Rate

Under §§ 1.987–1(c)(3)(i) and 1.987–2(d) of the 2006 proposed regulations, the historic rate used to translate the basis of historic assets was the spot rate on the date on which the asset was transferred to, or otherwise acquired by, a section 987 QBU. Thus, when assets were acquired by a section 987 QBU on multiple days during a single taxable year, the 2006 proposed regulations required taxpayers to track multiple historic spot rates. A comment observed that taxpayer systems often only identify the date an asset is placed in service and recommended that taxpayers be permitted to use a yearly average exchange rate in lieu of a spot rate in translating historic items.

The Treasury Department and the IRS agree that using the yearly average exchange rate rather than a spot rate to translate historic items would reduce complexity and improve administrability without introducing significant distortions into the determination of section 987 taxable income or loss or section 987 gain or loss. Accordingly, § 1.987–1(c)(3)(i) generally provides that the historic rate is the yearly average exchange rate for the taxable year when a historic asset is acquired, or a historic liability is incurred, by a section 987 QBU. Taxpayers that prefer to use the spot rate as the historic rate, as under the 2006 proposed regulations, may so elect under § 1.987–1(c)(1)(iii). A taxpayer that makes this election is deemed to also make the historic inventory election under § 1.987–3(c)(2)(iv)(B) that is described in Part II.A.3 of this preamble.

In addition, to further improve administrability, § 1.987–1(c)(3)(iii) permits a section 987 QBU that acquires depreciable or amortizable property in one year and places the asset in service in another year to determine the historic rate for the property based on the date the property is placed in service rather than the year the property was acquired, provided that this convention is consistently applied for all such property attributable to that section 987 QBU.

2. Prepaid Expenses and Liabilities Treated as Section 987 Marked Items

Comments suggested that prepaid expenses and liabilities for advance payments of unearned income should be treated as section 987 marked items because they typically have a short duration and often concern small amounts. The Treasury Department and the IRS have determined that treating these items as marked items generally would promote administrability without introducing significant distortions in the determination of section 987 gain or loss. Accordingly, the definition of marked item under § 1.987–1(d) includes prepaid expenses and liabilities for an advance payment of unearned income where such items have an original term of one year or less.

3. Cost of Goods Sold/Inventory

Under the 2006 proposed regulations, inventory was treated as a historic item. As a result, to determine section 987 taxable income or loss with respect to a section 987 QBU under proposed § 1.987–3, cost of goods sold (COGS) had to be translated at a historic spot rate that corresponded to the date the liquidated inventory was acquired or manufactured. A historic spot rate also had to be used to determine the OFCNV of the QBU under proposed § 1.987–4 with respect to inventory that was reflected on the section 987 QBU's year-end balance sheet. For these purposes, the cost basis of inventory purchased for resale generally would have been translated into the owner's functional currency at the spot rate on the date of purchase. With respect to inventory that was manufactured by the section 987 QBU, it would have been necessary to translate individually the various components of COGS at the appropriate historic spot rate for each cost component, resulting in an effective historic rate for manufactured inventory that was a blend of the historic rates applicable to such components. That is, labor, materials and other inventoriable costs would have been translated at the spot rate on the date the cost was incurred or, in the case of depreciation, the date the relevant depreciable asset was acquired. Comments suggested that translating inventoriable costs at their historic spot rates presented significant administrative difficulties. In addition to the comments requesting that certain high volume property be treated as a marked asset, one comment requested that a simplified method be provided to deal with the administrative difficulties in applying the 2006 proposed regulations to inventory.

In response to comments, these final regulations simplify the translation of COGS and ending inventory in two significant ways. First, the use under § 1.987–1(c)(3) of the yearly average exchange rate rather than a spot rate as the historic rate will significantly simplify the translation of COGS and ending inventory. This change makes it possible to translate all inventory purchased in a given year, and all costs incurred in the production of inventory in a given year (other than depreciation, which is always translated at the historic rate for the year the depreciated property was acquired or placed in service, regardless of whether it is an inventoriable cost), using a single exchange rate. Second, § 1.987–3(c)(2)(iv)(A) prescribes a simplified inventory method under which (i) COGS is translated into the functional currency of the section 987 QBU's owner at the yearly average exchange rate for the current taxable year with a requirement to make only two discrete adjustments to the translated COGS amount, and (ii) a simplified historic rate is used for purposes of determining the OFCNV under Reg. § 1.987–4 for inventory to which the simplified inventory method applies. A taxpayer that prefers the inventory method under the 2006 proposed regulations can elect under § 1.987–3(c)(2)(iv)(B) to translate inventoriable costs that are included in COGS or ending inventory at the historic rate for each such cost and, if they wish, can further elect under § 1.987–1(c)(1)(iii) to use the spot rate as the historic rate.

a. Translation of COGS under the simplified inventory method

Under the simplified inventory method, a section 987 QBU determines COGS in its functional currency and translates that amount at the yearly average exchange rate for the taxable year rather than translating each inventoriable cost at the appropriate historic rate. Taxpayers applying the simplified inventory method must make two adjustments to COGS described in § 1.987–3(c)(3). These adjustments mitigate the consequences of translating COGS at the yearly average exchange rate, as if inventory were a marked asset, rather than translating the inventoriable costs reflected in inventory sold during the taxable year at the appropriate historic rates, as under the 2006 proposed regulations. In particular, the adjustments generally prevent inventory from giving rise to section 987 gain or loss reflected in the FEEP. The adjustments also cause section 987 taxable income or loss to correspond over time to the section 987 taxable income or loss that would have resulted if inventoriable costs were translated at historic rates.

The first adjustment requires the translated COGS amount to be adjusted to reverse the effect of translating (as part of the translation of COGS) cost recovery deductions treated as inventoriable costs at the current yearly average exchange rate rather than at the appropriate historic rates. For a particular cost recovery deduction, this adjustment is calculated as the portion of the deduction treated as an inventoriable cost, computed in the functional currency of the QBU, multiplied by the amount (whether positive or negative) that is determined by subtracting the yearly average exchange rate at which COGS was translated from the historic rate applicable to the property whose cost is being recovered. For example, in a period in which the functional currency of a section 987 QBU has strengthened against its owner's functional currency, the adjustment would reduce the amount of COGS determined in the owner's functional currency to correspond to the amount that would have been determined if cost recovery deductions that are inventoriable costs had been translated at the historic rate, as other cost recovery deductions are translated. To enhance administrability and respond to comments received, this adjustment is taken into account in determining COGS in full in the taxable year in which the inventoriable cost recovery deductions are allowed, regardless of whether a portion of such costs is capitalized into ending inventory.

The second adjustment required under the simplified inventory method differs for inventory accounted for under the last-in, first-out (LIFO) method and for non-LIFO inventory, to reflect the different cost flow assumptions under these accounting methods. For both non-LIFO and LIFO inventory, the adjustment generally causes the amount of section 987 taxable income or loss taken into account by the owner of a section 987 QBU to correspond over time to the amount that would be taken into account if inventoriable costs were translated at their respective historic rates rather than at the yearly average exchange rate. For non-LIFO inventory, the adjustment is made on an annual basis with respect to beginning inventory. For LIFO inventory, the adjustment is made only when a LIFO layer is liquidated or partially liquidated.

i. adjustment for non-LIFO inventory

For non-LIFO inventory, the second adjustment required under the simplified inventory method is an adjustment with respect to beginning inventory. The adjustment, which must be made annually, corrects the distortion that arises from translating beginning inventory at the current yearly average exchange rate as part of translating COGS, after the same inventory was translated in the immediately preceding year (when the inventory represented ending inventory in the cost of goods calculation) at the yearly average exchange rate for that year. This adjustment to COGS is calculated as the amount of beginning inventory, computed in the functional currency of the QBU, multiplied by the amount (whether positive or negative) that is determined by subtracting the yearly average exchange rate for the current taxable year from the yearly average exchange rate for the immediately preceding taxable year. For example, in a period in which the functional currency of a section 987 QBU has strengthened against the owner's functional currency, this adjustment would reduce the amount of COGS determined in the owner's functional currency by the difference between beginning inventory translated at the current yearly average exchange rate and at the yearly average exchange rate for the immediately preceding taxable year.

Over time, this adjustment generally causes the owner of a section 987 QBU to take into account the same amount of section 987 taxable income or loss as would have occurred under the 2006 proposed regulations if the yearly average exchange rate had been used as the historic rate. Additionally, because this adjustment is reflected in section 987 taxable income or loss, which is a component of the § 1.987–4 calculation of section 987 gain or loss with respect to the section 987 QBU, the adjustment ultimately has the effect of preventing non-LIFO inventory on the year-end balance sheet from giving rise to section 987 gain or loss, notwithstanding that the historic rate at which it is translated each year is the yearly average exchange rate.

ii. adjustment for LIFO inventory

For LIFO inventory, the second adjustment required under the simplified inventory method is an adjustment with respect to LIFO layers liquidated in whole or part during the year. The adjustment, which must be made only in taxable years in which a LIFO layer is partially or fully liquidated, compensates for the translation of COGS attributable to a liquidated LIFO layer at the current yearly average exchange rate rather than at the historic rate associated with the taxable year in which the inventory layer arose. The adjustment is calculated as the amount of each LIFO layer that has been fully or partially liquidated during the year multiplied by the amount (whether positive or negative) that is determined by subtracting the yearly average exchange rate for the current taxable year from the yearly average exchange rate for the taxable year to which the liquidated layer relates.

As a result of this adjustment, each LIFO layer is treated as having a single historic rate, which is the yearly average exchange rate for the taxable year in which the layer arose.

b. Determination of the OFCNV of inventory under the simplified method

For purposes of determining section 987 gain or loss under § 1.987–4 with respect to inventory that is reflected on the section 987 QBU's year-end balance sheet, § 1.987–1(c)(3)(i)(B) provides a simplified historic rate for inventory to which the simplified inventory method applies. Under § 1.987–1(c)(3)(i)(B), the simplified historic rate for inventory differs depending on whether the inventory is accounted for under the LIFO method. If the inventory is accounted for under the LIFO method, the historic rate is the average exchange rate for the taxable year in which the relevant LIFO layer arose. If the inventory is accounted for under a non-LIFO method, the historic rate is the average exchange rate for the taxable year for which the determination of the historic rate is relevant. Accordingly, for purposes of determining section 987 gain or loss with respect to non-LIFO inventory reflected on a section 987 QBU's year-end balance sheet, the inventory is translated at the average exchange rate for that taxable year. Thus, although non-LIFO inventory subject to the simplified method is nominally a historic asset, it is translated at a current exchange rate each year similar to a marked asset, but using the yearly average exchange rate rather than the year-end spot rate.

4. Translation Rates Used for the Sale of a Marked Asset by a Section 987 QBU

The 2006 proposed regulations provided special rules for translating the adjusted basis and amount realized upon a disposition of a marked asset. For a marked asset that was held by a section 987 QBU on the first day of a taxable year, the required translation rate for the adjusted basis and amount realized with respect to the asset was the rate used to translate the basis of such asset from the section 987 QBU's functional currency into the owner's functional currency in determining the owner functional currency net value of the section 987 QBU for the preceding taxable year under § 1.987–4. For a marked asset acquired during the taxable year, the adjusted basis and amount realized were translated at the spot rate on the date the asset was acquired. In response to general comments on the complexity of administering the 2006 proposed regulations, and considering the relatively minor distortion that would arise from eliminating these special translation rules, the final regulations do not include a special rule for translating the adjusted basis or amount realized with respect to marked assets. Accordingly, the gain or loss on marked assets generally is determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the yearly average exchange rate for the year of disposition.

B. *Excluded entities*

The 2006 proposed regulations provided that banks, insurance companies, and similar financial entities would not be subject to the regulations. In addition, the 2006 proposed regulations identified leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts as "similar financial entities." A comment requested that the final regulations clarify the meaning of "similar financial entities." Comments also suggested excluding entities from the scope of "similar financial entity" (and therefore making such entities subject to the final regulations) if they primarily engage in transactions with related parties that are not themselves financial entities. A comment noted that it would be anomalous to apply the final regulations with respect to all of the operating entities transacting with a related finance coordination center but not apply the final regulations to the center itself.

The Treasury Department and the IRS agree that the reference to "similar financial entities" in the 2006 proposed regulations is unclear and agree that entities primarily engaged in transactions with related persons that are not themselves financial entities should be subject to the final regulations. Accordingly, § 1.987–1(b)(1)(ii) omits the reference to "similar financial entities," and replaces it with specific references to the entities that the 2006 proposed regulations explicitly identified as "similar financial entities." Additionally, the exception from the application of the final regulations is revised based on the comment received to not apply (such that the final regulations do apply) to entities that engage in transactions primarily with persons that are related within the meaning of sections 267(b) or 707(b) and that are not themselves entities identified in § 1.987–1(b)(1)(ii).

The preamble to the 2006 proposed regulations requested comments on the application of the FEEP method to entities excluded from the scope of the 2006 proposed regulations. The Treasury Department and the IRS are still considering how section 987 should apply to excluded entities and request additional comments regarding the appropriate design of rules applying section 987 to excluded entities in light of the rules contained in these final regulations and the temporary regulations. Until regulations providing rules for applying section 987 with respect to such excluded entities are effective, the excluded entities must use a reasonable method to comply with section 987 and cannot rely on these final regulations.

C. *Election to apply section 988 in lieu of section 987*

A comment recommended allowing an owner of a section 987 QBU that has a relatively small amount of marked items to elect to not apply section 987 with respect to the QBU and instead to apply section 988 with respect to the items that would be considered marked items of the QBU if section 987 applied. The same comment recommended that the Treasury Department and the IRS consider providing such an election more generally without regard to the relative amount of marked items held by an eligible QBU. The Treasury Department and the IRS have determined that the proposed election would create substantial administrative difficulties for the IRS, particularly given that an electing QBU would maintain books and records in its functional currency but would determine tax consequences by reference to the functional currency of the owner. Accordingly, the recommendation to allow an election not to apply section 987 has not been adopted.

D. *Definition of portfolio stock*

Under § 1.987–2(b)(2) of the 2006 proposed regulations, stock other than portfolio stock is not attributed to an eligible QBU even if it is reflected on the books and records of the eligible QBU. For this purpose, the 2006 proposed regulations provided that stock is portfolio stock if the owner of the eligible QBU owns (directly, indirectly, or constructively) less than 10 percent of the voting power or value of all classes of stock of the corporation. A comment recommended that this rule be based solely on value because voting power should not be a relevant factor in determining whether items of income, gain, deduction, and loss arising from stock are included in section 987 taxable income or loss. The Treasury Department and the IRS agree with this recommendation, which is reflected in § 1.987–2(b)(2).

E. *Consistency of attribution rules and QBU concept across subpart J*

A comment observed that the 2006 proposed regulations provide rules for attributing assets and liabilities, and items of income or expense, to an eligible QBU and that those rules should apply for purposes of sections 985, 987, and 989 to avoid inconsistencies across subpart J. Accordingly, § 1.989(a)–1(d)(3) is revised to provide that the principles of § 1.987–2(b) apply in determining whether an asset, liability, or item of income or expense is properly reflected on the books and records of a QBU.

To further enhance consistency, the definition of an eligible QBU in § 1.987–1(b)(3) is revised to cross-reference the QBU definition under § 1.989–1(a). The 1991 proposed regulations generally would have applied to a QBU within the meaning of § 1.989(a)–1 that has a functional currency different than the functional currency of its owner. The 2006 proposed regulations, in contrast, did not refer directly to the § 1.989–1(a) QBU definition. Rather, the 2006 regulations generally defined an eligible QBU as activities that constitute a trade or business as defined in § 1.989(a)–1(c) for which a separate set of books and records are maintained. By relying on the definition of a QBU in § 1.989(a)–1, as the 1991 proposed regulations did, the final regulations avoid inadvertently introducing inconsistencies across subpart J in the definition of a QBU.

F. *Offsetting positions*

Under § 1.987–2(b)(3)(iii)(C) of the 2006 proposed regulations, if a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU was the avoidance of U.S. tax under section 987, the Commissioner could reallocate any item between or among the eligible QBU, its owner, and other persons, entities, or eligible QBUs. One relevant factor identified in the 2006 proposed regulations as indicating tax avoidance as a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU was the presence or absence of an item on such books and records that results in the taxpayer (or a person related to the taxpayer as defined in section 267(b) or 707(b)) having offsetting positions in the functional currency of a section 987 QBU. The "offsetting position" concern might arise, for example, when a home office borrows funds denominated in the functional currency of a section 987 QBU and then onlends those funds to its section 987 QBU. Since the intra-taxpayer loan is not recognized, the funding transaction booked to the home office will be a section 988 transaction and the cash booked to the section 987 QBU derived from the funding transaction will be subject to section 987. A comment recommended that the Treasury Department and the IRS restrict the parameters of the "offsetting position" factor, particularly in the context of banks.

As discussed in Part II.B of this preamble, these regulations do not apply to banks. Accordingly, this comment will be reconsidered when regulations applying section 987 to banks and other financial entities are developed. Outside of the financial entity context, the Treasury Department and the IRS have determined that the "offsetting position" factor in § 1.987–2(b)(3)(iii)(C) is necessary to prevent the use of transactions involving offsetting gains and losses to selectively recognize losses without recognition of gain. Accordingly, the recommendation to restrict the parameters of the "offsetting position" factor has not been adopted.

G. *Exclusion of ordinary-course transactions from the definition of a transfer*

Several comments recommended that transactions entered into between two section 987 QBUs of the same taxpayer, or by a section 987 QBU and its home office, in the ordinary course of business should not be considered "transfers" that are taken into account in determining the amount of a remittance. These comments noted the complexity associated with tracking a large number of ordinary-course transactions and contended that such transactions were not appropriate occasions to recognize section 987 gain or loss.

The Treasury Department and the IRS have determined that it is not feasible to define the parameters of an ordinary-course exception to the definition of a transfer with sufficient clarity to avoid abuse and permit effective enforcement given the potentially high volume and variety of transactions between a section 987 QBU and its home office. More significantly, determining the net transfer to or from a section 987 QBU, without regard to whether transfers occur in the ordinary course of business, is essential for appropriately determining section 987 gain or loss under § 1.987–4 because all transfers affect the OFCNV of the section 987 QBU. Furthermore, the Treasury Department and the IRS have determined that the annual netting convention of § 1.987–5, which simplifies the calculation of a remittance relative to the 1991 proposed regulations by taking into account only the net transfer to or from a section 987 QBU during a taxable year, appropriately limits the extent to which ordinary course transactions between a section 987 QBU and its home office give rise to a remittance. Accordingly, the recommendation to include an ordinary-course exception to the definition of transfer has not been adopted.

A comment also recommended that the final regulations permit taxpayers to elect to treat disregarded sales of property and services in the ordinary course of business as regarded transactions. The Treasury Department and the IRS have determined that this recommendation, which would result in income or loss recognition on intra-taxpayer transactions, is inconsistent with the paradigm of section 987 and the entity classification regulations under section 7701. Accordingly, the recommendation has not been adopted.

H. *Extension of the grouping rules*

Section 1.987–1(b)(2)(ii) of the 2006 proposed regulations allows a taxpayer to elect to treat all of its directly owned section 987 QBUs with the same functional currency as a single QBU for purposes of section 987. This rule, however, does not allow different members of a consolidated group to group their section 987 QBUs with the same currency into a single QBU. In the preamble to the 2006 proposed regulations, the Treasury Department and the IRS requested comments on whether a grouping election should be allowed with respect to section 987 QBUs owned by different members of a consolidated group and how this election should be technically effectuated.

Several comments recommended extending the grouping rules to corporations that file a consolidated return so that a consolidated group could make transfers among section 987 QBUs without causing a remittance. However, based on the comments received, the Treasury Department and the IRS have been unable to reconcile in a satisfactory manner the timing of section 987 gain or loss and section 987 taxable income or loss under the final regulations with the principles of § 1.1502–13, including separate entity accounting for consolidated group members. As a result, this recommendation has not been adopted in the final regulations. The Treasury Department and the IRS continue to welcome comments with specific recommendations regarding how grouping of section 987 QBUs owned by different consolidated group members could be achieved in a manner consistent with the consolidated return regulations.

A comment requested an election to group section 987 QBUs that are directly owned with section 987 QBUs that are indirectly owned through section 987 aggregate partnerships. The Treasury Department and the IRS have determined that allowing grouping of directly and indirectly owned section 987 QBUs would be inconsistent with the treatment of transactions between a partnership and its partner (and between eligible QBUs of the partnership and of the partner) as regarded transactions for Federal income tax purposes. Additionally, it is unclear how the treatment of directly and indirectly owned section 987 QBUs as a single section 987 QBU could be reconciled with the general requirement under sections 702 and 703 that a partnership determine its income separately. Due to the uncertainties about how directly and indirectly owned section 987 QBUs could be grouped in a manner consistent with the principles of subchapter K, the recommendation has not been adopted.

A comment requested that an owner be permitted to elect to group less than all of its section 987 QBUs with the same functional currency. The Treasury Department and the IRS observe that it is possible for an owner to have section 987 gain with respect to some of its section 987 QBUs and section 987 loss with respect to other section 987 QBUs with the same functional currency. In light of this possibility, the Treasury Department and the IRS are concerned that the ability to group section 987 QBUs without the constraint of a consistency requirement for all section 987 QBUs with the same functional currency could inappropriately facilitate the recognition of section 987 losses coupled with the deferral of section 987 gains. Accordingly, the recommendation has not been adopted.

I. *Adjustment of the computation of net unrecognized exchange gain or loss for tax-exempt income and non-deductible expenses*

Section 1.987–4 of the 2006 proposed regulations provided a seven-step process for determining the unrecognized section 987 gain or loss of a section 987 QBU for a taxable year. Comments noted that this calculation did not take into account the effects of tax-exempt income and nondeductible expenses on a section 987 QBU's cash flows. The comments advised that this omission would introduce distortions into the calculation of unrecognized section 987 gain or loss for a taxable year since these items affect a section 987 QBU's balance sheet. In response to these comments, § 1.987–4(d) reflects additional steps in the calculation of unrecognized section 987 gain or loss that account for nondeductible expenses (Step 7) and tax-exempt income (Step 8). Step 7 also now explicitly accounts for foreign taxes claimed as a credit, which must be translated at the same rate at which such taxes were translated under section 986(a).

J. *Clarification that the rules of §§ 1.987–3 and –4 apply for determining the E&P of a corporation*

Comments indicated that the 2006 proposed regulations did not clearly specify whether the rules provided for determining section 987 taxable income or loss applied for purposes of determining the earnings and profits of a foreign corporation. Accordingly, § 1.987–3(a) clarifies that a foreign corporation that owns a section 987 QBU must apply § 1.987–3 in determining earnings and profits with respect to the section 987 QBU.

K. *FEEP annual calculation requirement*

Section 1.987–4(a) of the 2006 proposed regulations required the determination of the net unrecognized section 987 gain or loss of a section 987 QBU by the owner annually. In addition, § 1.987–9 of the 2006 proposed regulations required the taxpayer to keep annual records that are sufficient to establish each section 987 QBU's section 987 gain or loss. A comment requested elimination of these annual calculations and recordkeeping requirements. The Treasury Department and the IRS remain of the view that the annual calculation and recordkeeping requirements are necessary for IRS examiners to verify taxpayer compliance with the final regulations. Based on its experience examining taxpayer positions that relate to events in prior years, the IRS has determined that contemporaneous recordkeeping and calculation requirements provide a significantly more reliable basis for verifying compliance than calculations performed years after the relevant events, which in many cases would be performed by individuals without direct access to the individuals most familiar with the underlying facts or responsible for producing and maintaining the records. Accordingly, the annual requirements have been retained.

L. *Character and source of section 987 gain or loss*

Consistent with the 1991 proposed regulations, the 2006 proposed regulations required the owner of a section 987 QBU to determine the character and source of section 987 gain or loss for all purposes of the Code, including for determining the extent to which section 987 gain or loss gives rise to subpart F income. In particular, § 1.987–6(b)(2) of the 2006 proposed regulations required the owner to use the asset method under § 1.861–9T(g) in the year of a remittance to characterize and source section 987 gain or loss for all purposes by reference to the assets of the section 987 QBU.

A comment recommended an exception that would allow a taxpayer to elect to trace identified amounts of section 987 gain or loss to particular assets or liabilities and to characterize such gain or loss by reference to the income or expense derived (or to be derived) from such items. The Treasury Department and the IRS have determined that tracing section 987 gain or loss to particular assets and liabilities is inconsistent with the FEEP method, which aggregates and pools section 987 gain and loss for all assets and liabilities and for all years prior to a remittance. Accordingly, the Treasury Department and the IRS decline to adopt this comment.

A comment questioned whether section 987(3), which refers to sourcing section 987 gain or loss by reference to post-1986 accumulated earnings, provided a sufficient basis for characterizing section 987 gain or loss as subpart F income. The comment recommended against treating section 987 gain as subpart F income but also recommended that, if it were so treated, the final regulations provide a business needs exception similar to that under section 954(c)(1)(D). Another comment acknowledged the Treasury Department's authority under section 989(c)(5) to characterize section 987 gain as subpart F income but questioned the consistency of the requirement in the 2006 proposed regulations to use the asset method of § 1.861–9T to characterize section 987 gain or loss with the reference in section 987(3) to sourcing section 987 gain or loss by reference to post-1986 accumulated earnings. The comment recommended that the character and source of section 987 gain or loss be determined by reference to post-1986 accumulated earnings.

The Treasury Department and the IRS have determined that sourcing and characterizing section 987 gain or loss with direct reference to post-1986 accumulated earnings would give rise to substantial complexity and compliance burdens, including the need to track earnings of a section 987 QBU in separate categories over a long period of time. This approach also presents conceptual difficulties, given that section 987 gain or loss arises from marked assets and liabilities rather than accumulated earnings, and allows for planning opportunities if there are deficits in post-1986 accumulated earnings. The Treasury Department and the IRS continue to believe that, as noted in the preamble to the 2006 proposed regulations, the average tax book value of assets is a reasonable proxy for post-1986 accumulated earnings in the context of section 987. For these reasons, the Treasury Department and the IRS decline to adopt this recommendation. Pursuant to sections 987(3) and 989(c)(5), these regulations follow the approach of the 2006 proposed regulations in requiring the owner to use the asset method of § 1.861–9T(g) to characterize and source section 987 gain or loss. The final regulations, however, do clarify that in applying the asset method, an owner must consistently determine the value of a section 987 QBU's assets on the basis of either the tax book value or the fair market value of the assets.

Additionally, given the significant symmetry (other than timing) between the FEEP paradigm and section 988, the Treasury Department and the IRS have determined that, for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D), it is appropriate for taxpayers to treat section 987 gain or loss that is characterized by reference to assets that give rise to subpart F income as foreign currency gain or loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation (CFC). This policy, which has been adopted in § 1.987–6(b)(3), will allow taxpayers to offset a section 987 net loss characterized by reference to assets that give rise to subpart F income against a section 988 net gain, and vice versa, in determining subpart F income. Section 987 gain or loss characterized by reference to assets that give rise to subpart F income is treated as attributable to section 988 transactions not directly related to the business needs of the CFC because the Treasury Department and the IRS have determined that using the asset method of § 1.861–9T(g) to characterize and source section 987 gain or loss effectively carries out the purpose of the business needs exclusion of section 954(c)(1)(D). In particular, because the asset method characterizes section 987 gain or loss based on whether assets give rise to subpart F income, section 987 gain or loss will not enter into the determination of foreign personal holding company income to the extent assets of the section 987 QBU do not give rise to subpart F income.

M. *Partnerships*

The 2006 proposed regulations applied to all partnerships based on an approach (the aggregate approach) that treated a partnership as an aggregate of its partners, rather than as an entity separate from its partners. As explained in the preamble to the 2006 proposed regulations, the Treasury Department and the IRS proposed the aggregate approach because it appropriately determines section 987 gain or loss with respect to partnership assets and liabilities by reference to the functional currencies of the partners that ultimately bear the economic exposure to fluctuations in the exchange rate between their own functional currency and the functional currency of the activities of the partnership. Accordingly, under §§ 1.989(a)–1(b)(2)(i) of the 2006 proposed regulations, a partnership itself was not treated as a section 987 QBU, but certain activities of a partnership that constituted a trade or business could qualify as a QBU that is an eligible QBU of a partner. Thus, a partner generally was treated as owning an eligible QBU consisting of a share of the assets and liabilities held in the partnership's trade or business. Such an eligible QBU could qualify as a section 987 QBU if it had a functional currency different from that of the partner.

Comments requested that the Treasury Department and the IRS reconsider this aggregate approach and that final regulations instead treat a partnership as a separate entity with its own functional currency. The comments generally were premised on the concern that the aggregate approach was overly complex and that minority partners would not have the power to compel a partnership to provide them with the information needed to make the calculations required under the aggregate approach. One comment acknowledged the economic rationale for the aggregate approach but, in light of its complexity, recommended that it apply only in cases in which a partner's interest in partnership capital or profits exceeds a certain threshold, such as 10 percent.

The Treasury Department and the IRS acknowledge the concerns expressed about the complexity of applying the aggregate approach in the context of partnerships with partners that are unrelated to each other. Nonetheless, consistent with the comment recommending the aggregate approach for partners with substantial partnership interests, the Treasury Department and the IRS have determined that it is feasible to administer the aggregate approach with respect to a partnership that is wholly owned by related persons. Moreover, adopting the aggregate approach in that context is important for preventing planning opportunities that would arise if the interposition of a partnership within a group of related parties could significantly alter the results that the group otherwise would experience under section 987 without meaningfully altering the group's economic position. Accordingly, the final section 987 regulations retain the aggregate approach of the 2006 proposed regulations only for so-called "section 987 aggregate partnerships," which are defined in § 1.987–1(b)(5) as partnerships for which all of the capital and profits interests are owned, directly or indirectly, by persons that are related within the meaning of section 267(b) or 707(b). The final regulations reflect a conforming amendment to the definition of a QBU at § 1.989(a)–1(b)(2)(i)(C), which now provides that a partnership, other than a section 987 aggregate partnership, is a QBU.

The 2006 proposed regulations provided a rule for determining a partner's share of the assets and liabilities of an eligible QBU owned indirectly through a partnership. Specifically, § 1.987–7(b) provided that a partner's share of assets and liabilities reflected on the books and records of the eligible QBU must be determined in a manner consistent with how the partners have agreed to share the economic benefits and burdens corresponding to partnership assets and liabilities, taking into account the rules and principles of subchapter K. One comment noted that this rule for allocating assets and liabilities to a partner's indirectly owned section 987 QBU was ambiguous and that the rules and principles of subchapter K do not provide sufficient guidance in this regard. Accordingly, as discussed in the preamble to the temporary regulations, the temporary regulations provide more specific rules for determining a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership.

As previously discussed in this section, comments recommended that the Treasury Department and the IRS consider adopting an entity approach with respect to partnerships. Under the recommended entity approach, a partnership would have its own functional currency and would apply section 987 with respect to each of its section 987 QBUs to determine its taxable income or loss and section 987 gain or loss in that functional currency. Each partner then would be required to take into account its share of the section 987 taxable income or loss and section 987 gain or loss of the partnership, translated into the partner's functional currency at the average exchange rate for the partner's taxable year.

Although the Treasury Department and the IRS have determined that the aggregate approach is appropriate for applying section 987 to section 987 aggregate partnerships, the Treasury Department and the IRS anticipate that regulations for applying section 987 to other partnerships (non-aggregate partnerships) will be developed under a separate project and may adopt a different approach. Accordingly, the Treasury Department and the IRS request comments describing how an entity approach might apply to non-aggregate partnerships, including comments on (1) whether and how section 987 should apply to marked items denominated in the non-aggregate partnership's functional currency, (2) the information reporting that would be necessary to apply an entity approach, (3) whether a distinction should be made regarding how section 987 applies with respect to partnerships in which significant U.S. partners and CFCs together own more than 50 percent of the capital and profits interests in the partnership, and (4) the rules that would be needed to coordinate with subchapter K.

N. *Terminations*

Under the 2006 proposed regulations, a section 987 QBU terminates when the activities of the section 987 QBU cease, substantially all of the assets of the section 987 QBU are transferred to its owner, a CFC owner of a section 987 QBU ceases being a CFC, or the owner of the section 987 QBU ceases to exist in a transaction other than certain liquidations and reorganizations described in section 381(a). The preamble to the 2006 proposed regulations requested comments on whether transfers of some or all of the assets of a section 987 QBU from one member of a consolidated group to another member of the group should result in a remittance or termination, respectively. Several comments supported a rule under which a section 351 transfer of some or all of the assets of a section 987 QBU to other members of a consolidated group would not cause a remittance or termination where those assets continue to be held in a section 987 QBU following the transaction.

The Treasury Department and the IRS remain of the view that a transfer of substantially all of a section 987 QBU's assets and liabilities under section 351 should result in a termination under § 1.987–8(b)(2) because the owner ceases to be subject to section 987 with respect to the section 987 QBU and has no successor in a section 381(a) transaction. Nonetheless, the Treasury Department and the IRS agree that it is appropriate in certain circumstances to defer section 987 gain or loss that otherwise would be recognized as a result of certain transactions, including terminations, that result in deemed transfers from a section 987 QBU where some or all of the assets of the section 987 QBU continue to be reflected on the books and records of a section 987 QBU in the same controlled group. Additionally, the Treasury Department and the IRS have determined that combinations and separations of section 987 QBUs of the same owner generally should not result in recognition of section 987 gain or loss. As discussed in the preamble to the temporary regulations, the temporary regulations provide rules under which certain section 987 gain or loss that otherwise would be recognized upon a combination, separation, termination, or other event with respect to a section 987 QBU is deferred and recognized upon a subsequent event to the extent assets of the section 987 QBU continue to be reflected on the books and records of a section 987 QBU in the same controlled group. Under these rules, a section 351 transfer of some or all of the assets of a section 987 QBU within a consolidated group generally would not result in recognition of section 987 gain or loss, provided the transferred assets continue to be reflected on the books and records of a section 987 QBU.

Comments recommended eliminating the rule in the 2006 proposed regulations under which a section 987 QBU terminates upon its owner ceasing to be a CFC. The comments indicated that the rule is inconsistent with the policy of subpart F and section 1248. One of the comments questioned the authority under subpart J for such a rule. A comment also recommended that the final regulations eliminate the rule under which a section 987 QBU terminates when it is acquired by a non-CFC from a CFC owner in a reorganization in which the CFC owner goes out of existence but has a successor under section 381(a). The Treasury Department and the IRS acknowledge that the policy concern motivating these rules pertains primarily to situations in which a section 987 QBU ceases to be owned by a CFC but continues to be owned by related persons within the meaning of section 267(b). Accordingly, consistent with section 989(c)(5), a section 987 QBU will terminate under § 1.987–8(b)(3), (b)(4) and (c) only in that circumstance.

Comments indicated that it was unclear under the 2006 proposed regulations whether a check-the-box election to treat a foreign disregarded entity that legally owns a section 987 QBU as a corporation for U.S. tax purposes would cause the section 987 QBU to terminate. To provide greater clarity, *Example 6* in § 1.987–8(f) illustrates that when a foreign disregarded entity that legally owns a section 987 QBU elects to be treated as a corporation under the check-the-box regulations in § 301.7701–3, the section 987 QBU terminates due to the deemed transfer of assets from the section 987 QBU to the owner immediately prior to the deemed transfer of assets from the owner to the transferee corporation under section 351. Additionally, § 1.987–2(c)(2)(ii) clarifies that if an asset or liability of a section 987 QBU is sold or exchanged (including in a nonrecognition transaction) for an asset or liability that is not attributable to the section 987 QBU immediately after the exchange (for example, non-portfolio stock deemed to be received in a section 351 exchange), the exchanged asset is treated as transferred from the section 987 QBU to its owner in a disregarded transaction immediately before the exchange. This transfer would be taken into account in determining the amount of the remittance from the section 987 QBU under § 1.987–5.

Under the 2006 proposed regulations, a section 987 QBU terminates when its activities cease, such that it no longer meets the definition of an eligible QBU under § 1.987–1(b)(3). For administrative convenience, § 1.987–8(b)(1) reflects a new provision allowing the owner of a section 987 QBU that ceases its trade or business to continue to treat the section 987 QBU as a section 987 QBU for a reasonable period during the wind-up of the trade or business, which period may not exceed two years from the date the section 987 QBU ceases its activities carried on for profit.

O. *Transition rules*

Under the 2006 proposed regulations, a taxpayer that used a reasonable method to comply with section 987 prior to transitioning to the final regulations could choose between the deferral transition method and the fresh start transition method. The deferral transition method generally preserved section 987 gain or loss determined under the taxpayer's prior method, whereas the fresh start method did not.

Under the deferral transition method, a taxpayer would determine section 987 gain or loss under the taxpayer's prior method as if all section 987 QBUs of the taxpayer terminated on the last day of the taxable year preceding the transition date. Such section 987 gain or loss was not recognized but rather was considered as net unrecognized section 987 gain or loss of new section 987 QBUs for purposes of applying section 987 to the taxable year that begins on the transition date. The owner of a section 987 QBU that was deemed terminated under this rule was treated as having transferred all of the assets and liabilities attributable to such section 987 QBU to the new section 987 QBU on the transition date. Exchange rates for translating the amounts of assets and liabilities transferred to the new section 987 QBU were determined with reference to the historic spot rates for such assets and liabilities, adjusted to take into account gain or loss determined on the deemed termination.

Under the fresh start transition method, the same deemed transactions would be deemed to occur as under the deferral transition method, but no section 987 gain or loss would be determined upon the deemed termination. Exchange rates for translating the amounts of assets and liabilities deemed transferred to the new section 987 QBU were determined with reference to the historic spot rates for such assets and liabilities without adjustment. Accordingly, section 987 gain or loss determined under the owner's prior method was not taken into account. Except to the extent of any previously recognized section 987 gain or loss, the effect of the fresh start method is as if the assets and liabilities on the books and records of a section 987 QBU on the transition date had been the only assets and liabilities held by the QBU from its inception.

The Treasury Department and the IRS received several comments recommending changes to the transition rules under § 1.987–10 of the 2006 proposed regulations. One comment recommended that the deferral transition method be eliminated. The comment stated that the availability of two transition methods seemed overly generous to taxpayers and that the fresh start method was sufficient. The comment further noted that the effect of the elections made by taxpayers would be very one-sided in a manner detrimental to the fisc. Another comment recommended that taxpayers be permitted to elect a "true fresh start" method that would translate all assets and liabilities on the first opening balance sheet after the transition at the spot rate on the date of transition and therefore disregard any section 987 gain or loss attributable to the assets and liabilities of the QBU for periods prior to the transition date.

The Treasury Department and the IRS agree with the comment that suggested that the fresh start method is sufficient and that the availability of an election between two different transition methods is unnecessary and detrimental to the fisc. By requiring the translation of assets and liabilities of transitioning QBUs at historic rates, unlike the "true fresh start" method suggested by a comment, the fresh start transition method appropriately takes into account the applicability of section 987 prior to the issuance of final regulations. Allowing an election to use the deferral method would allow taxpayers with substantial overall section 987 losses determined under their prior method, which may not correspond to economic losses, to preserve those losses while taxpayers with substantial overall section 987 gains determined under their prior method could avoid taking some of those gains into account by using the fresh start method. Such an election effectively would operate as a one-time election for certain taxpayers to reduce Federal income tax liability. Additionally, the Treasury Department and the IRS have determined that there would be considerable administrative difficulty, as well as potential for opportunistic planning, associated with determining the appropriate translation rates for transitioning under the deferral method from a section 987 method other than the method of the 1991 proposed regulations. Accordingly, the final regulations do not include an election to use the deferral method. Additionally, the final regulations do not include an election to use a "true fresh start" method, since that method would fail to account in any way for the applicability of section 987 prior to the transition date with respect to assets and liabilities held by a section 987 QBU on the transition date.

A comment recommended that the final regulations provide further guidance on the application of the fresh start method where a taxpayer cannot trace historic spot exchange rates. In response to this comment, § 1.987–10(b)(3) provides that, if a taxpayer cannot reliably determine the historic rate for a particular asset or liability, the historic rate must be determined based on reasonable assumptions consistently applied. In addition, the general rules of § 1.987–1(c)(3)(i)(A) and (D) ease this burden by providing that the historic rate for assets and liabilities is the relevant yearly average exchange rate, rather than the spot rate.

A comment recommended that taxpayers be permitted to elect retroactively to apply the final regulations to all open years. Such an election effectively would operate as one-time election to reduce Federal income tax liability. Additionally, consistent with the discussion in Part II.K of this preamble about the need for contemporaneous recordkeeping, the Treasury Department and the IRS have determined that retroactive application of the final regulations would present significant administrative and compliance difficulties, given that it would be necessary in many cases to make determinations under the final regulations based on facts that may not be readily ascertainable or verifiable in hindsight. Accordingly, this recommendation has not been adopted.

A comment asserted that taxpayers that recognized section 987 gain or loss under the principles of the 1991 proposed regulations may be treated unfairly relative to taxpayers that did not follow those proposed regulations. To address this perceived unfairness, the comment recommended that taxpayers be permitted to elect to include a section 481(a) adjustment to account for the difference between the amount of section 987 gain or loss that was taken into account under the taxpayer's prior method and the amount that would have been determined under the method in the final regulations. As an initial matter, it is not evident to the Treasury Department and the IRS that any inequity could result from a taxpayer's chosen method of applying section 987, given that, in the absence of applicable regulations, taxpayers have been permitted to apply section 987 using any reasonable method. Regardless of any perceived inequity, however, as discussed earlier in this Part II.O of the preamble, the Treasury Department and the IRS have determined that the fresh start transition method is the appropriate method for transitioning section 987 QBUs to the final regulations. Under the fresh start transition method, unrecognized section 987 gain or loss determined under a prior section 987 method is not taken into account, and marked assets and liabilities reflected on a section 987 QBU's balance sheet on the transition date are translated using a historic rate. These rules, together with the requirement under § 1.987–10(d) to adjust unrecognized section 987 gain or loss to prevent double counting, have a similar effect as allowing a section 481(a) adjustment with respect to section 987 gain or loss arising from assets and liabilities reflected on a section 987 QBU's transition date balance sheet. Additionally, it is unclear how a section 481(a) adjustment could apply with respect to section 987 gain or loss arising from assets and liabilities that are no longer on the balance sheet on the transition date, absent a requirement to redetermine section 987 gain or loss as if the final regulations had applied from the inception of the QBU. For the reasons described in Part II.K of this preamble, the Treasury Department and the IRS have determined that such a requirement would be inadministrable. Furthermore, the Treasury Department and the IRS are concerned that an election to compute a full section 481(a) adjustment, like an election to use the deferral method, effectively would operate as a one-time election to reduce Federal income tax liability. Accordingly, for the foregoing reasons, this recommendation has not been adopted.

The Treasury Department and the IRS recognize that certain taxpayers have adopted a section 987 method based on a reasonable application of the 2006 proposed regulations (2006 method). Taxpayers that adopted the 2006 method generally already transitioned to that method in accordance with the principles § 1.987–10 of the 2006 proposed regulations. Because the final regulations adopt the 2006 proposed regulations without fundamental changes, it is not necessary or appropriate for taxpayers to transition from the 2006 method to the final regulations under the fresh start method. However, § 1.987–10(c)(2) provides rules clarifying how net unrecognized section 987 gain or loss with respect to a QBU that was subject to the 2006 method is determined under the final regulations. Additionally, because the 2006 proposed regulations required the use of a spot rate for the historic rate and the final regulations specify as a general rule that the historic rate is the yearly average exchange rate, § 1.987–10(c)(3) permits taxpayers to use historic rates determined under their prior 2006 method for assets and liabilities reflected on the balance sheet of a transitioning QBU on the transition date.

P. *Elections*

Several elections have been included in the final regulations to mitigate potential complexity or administrative burden associated with complying with these regulations. Section 1.987–1(g) provides rules for making elections. As under the 2006 proposed regulations, elections must be made by the owner and must be made for the first taxable year in which the election is relevant in determining the section 987 taxable income or loss or section 987 gain or loss of the section 987 QBU. Elections may not be revoked or changed without the consent of the Commissioner or his delegate. A revocation will be considered if the taxpayer can demonstrate significantly changed circumstances or other circumstances that demonstrate a substantial non-tax business reason for revoking the election.

A comment recommended that the final regulations allow a taxpayer, without the consent of the Commissioner, to adopt or change the translation conventions for any section 987 QBU acquired from an unrelated person in a transaction that does not cause the QBU to terminate. The Treasury Department and the IRS have determined that requiring Commissioner consent to change an election in this circumstance promotes the ability of the IRS to administer the final regulations and does not create an undue burden. Accordingly, this recommendation has not been adopted.

With one exception, the elections under the final regulations are made on a QBU-by-QBU basis. As provided under the 2006 proposed regulations and described in Part II.H of this preamble, an owner must make the grouping election described in § 1.987–1(b)(2)(ii) with respect to all of its section 987 QBUs that have the same functional currency.

The 2006 proposed regulations described elections made under section 987 as methods of accounting but provided procedures for making and revoking such elections that were inconsistent with treating the elections as methods of accounting. This inconsistency is resolved in the final regulations, which do not follow the 2006 proposed regulations in identifying all section 987 elections as methods of accounting and clarify at § 1.987–1(g)(4) that an election under section 987 is not governed by the general rules concerning changes in methods of accounting.

Under § 1.987–1(f) of the 2006 proposed regulations, an election was made by attaching a statement to the timely filed tax return for the first taxable year in which the owner intends the election to be effective. If the owner failed to make an election in a timely manner, the owner was considered to have satisfied the timeliness requirement if (1) the owner was able to demonstrate that the failure was due to reasonable cause and not willful neglect; and (2) once the owner became aware of the failure, the owner attached the election as well as a written statement setting forth the reasons for the failure to timely comply to an amended tax return. The Director of Field Operations had 120 days following the filing to respond if it determined that the failure to comply was not due to reasonable cause or if additional time was needed to make a determination. If the Director did not respond to the taxpayer within 120 days of filing, the owner was deemed to have demonstrated that such failure to timely file was due to reasonable cause.

The Treasury Department and the IRS have determined, in part based on the experience of the IRS in administering other regulations, that the procedures described in the 2006 proposed regulations may inappropriately shift to the IRS a burden that arises in the first instance as a result of a taxpayer's failure to make a timely election. Accordingly, those procedures are not included in the final regulations, and taxpayers who fail to make a timely election may seek relief in accordance with the general rules described in § 301.9100–1 for requesting an extension of time to make an election.

Q. *Other changes*

The final regulations reflect other modifications to the language and structure of the 2006 proposed regulations, as well as the inclusion of additional examples, to enhance clarity. The Treasury Department and the IRS do not intend these changes to be interpreted as substantive changes to the 2006 proposed regulations.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Accordingly, a regulatory flexibility analysis is not required. This certification is based on the fact that these regulations will primarily affect U.S. corporations that have foreign operations, which tend to be larger businesses. Pursuant to section 7805(f) of the Internal Revenue Code, the NPRM preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these final regulations are Mark E. Erwin, Steven D. Jensen and Sheila Ramaswamy of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

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Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 987, 989(c), and 7805 * * *

Par. 2. Section 1.861–9T is amended by revising paragraph (g)(2)(ii)(A)(*1*) aind adding paragraph (g)(2)(vi) to read as follows:

§ 1.861–9T Allocation and apportionment of interest expense (temporary).

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(A) * * *

(*1*) *Section 987 QBU*. In the case of a section 987 QBU (as defined in § 1.987–1(b)(2)), the tax book value shall be determined by applying the rules of paragraphs (g)(2)(i) and (g)(3) of this section to the beginning-of-year and end-of-year functional currency amount of assets. The beginning-of-year functional currency amount of assets shall be determined by reference to the functional currency amount of assets computed under § 1.987–4(d)(1)(i)(B) and (e) on the last day of the preceding taxable year. The end-of-year functional currency amount of assets shall be determined by reference to the functional currency amount of assets computed under § 1.987–4(d)(1)(i)(A) and (e) on the last day of the current taxable year. The beginning-of-year and end-of-year functional currency amount of assets, as so determined within each grouping, must then be averaged as provided in paragraph (g)(2)(i) of this section.

* * * * *

(vi) *Effective/applicability date*. Generally, paragraph (g)(2)(ii)(A)(*1*) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then paragraph (g)(2)(ii)(A)(*1*) of this section shall apply to taxable years beginning on or after the first day of such prior taxable year.

* * * * *

Par 3. Section 1.985–5 is revised to read as follows:

§ 1.985–5 Adjustments required upon change in functional currency.

(a) *In general*. This section applies in the case of a taxpayer or qualified business unit (QBU) (including a section 987 QBU (as defined in § 1.987–1(b)(2)) changing from one functional currency (old functional currency) to another functional currency (new functional currency). A taxpayer or QBU subject to the rules of this section shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. Except as otherwise provided in this section, the adjustments shall be made on the last day of the last taxable year ending before the year of change (as defined in § 1.481–1(a)(1)). Gain or loss required to be recognized under paragraphs (b), (d)(2), (e)(2), and (e)(4)(iii) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income on the last day of the last taxable year ending before the year of change.

(b) *Step 1—Taking into account exchange gain or loss on certain section 988 transactions*. The taxpayer or QBU shall recognize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A) through (C)) that, after applying section 988(d), is denominated in terms of or determined by reference to the new functional currency. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (that is, whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988.

(c) *Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items*. Except as otherwise provided in this section, the new functional currency adjusted basis of property and the new functional currency amount of liabilities and any other relevant items (for example, items described in section 988(c)(1)(B)(iii)) shall equal the product of the old functional currency adjusted basis or liability and the new functional currency/old functional currency spot rate on the last day of the last taxable year ending before the year of change.

(d) *Step 3A—Additional adjustments that are necessary when a QBU changes functional currency*—(1) *QBU changing to a functional currency other than the owner's functional currency*—(i) *Rule*. If a QBU changes its functional currency, and after the change the QBU is a section 987 QBU that is subject to §§ 1.987–1 through 1.987–11 pursuant to § 1.987–1(b)(1), then the adjustments described in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section shall be taken into account for purposes of section 987.

(ii) *QBU and the owner had different functional currencies prior to the change*. If the QBU and the owner of the QBU had different functional currencies prior to the change and as a result the QBU was a section 987 QBU prior to the change, then the adjustments described in paragraphs (d)(1)(ii)(A) and (d)(1)(ii)(B) of this section shall be taken into account.

(A) *Determining new historic rates*. The historic rate (as defined in § 1.987–1(c)(3)) for the year of change and subsequent taxable years with respect to a historic item (as defined in § 1.987–1(e)) reflected on the balance sheet of the section 987 QBU immediately prior to the year of change shall be equal to the historic rate prior to the year of change (that is, a rate that translates the section 987 QBU's old functional currency into the owner's functional currency) divided by the spot rate (as defined in § 1.987–1(c)(1)) for translating an amount denominated in the section 987 QBU's old functional currency into the section 987 QBU's new functional currency on the last day of the last taxable year ending before the year of change. For example, if a taxpayer with a U.S. dollar (USD) functional currency owns a section 987 QBU that changes from a British pound (GBP) functional currency to a euro (EUR) functional currency, the historic rate for translating a specific historic item of this section 987 QBU from GBP to USD is 1.50, and the spot rate for translating GBP to EUR on the last day of the last taxable year before the change is 1.30, then the new historic rate for translating this historic item from EUR to USD is 1.15 (1.50/1.30).

(B) *Determining the owner functional currency net value of the QBU on the last day of the last taxable year ending before the year of change under § 1.987–4(d)(1)(i)(B)*. For purposes of determining the owner functional currency net value of the section 987 QBU on the last day of the last taxable year ending before the year of change under § 1.987–4(d)(1)(i)(B) and § 1.987–4(e), the section 987 QBU's marked items (as defined in § 1.987–1(d)) shall be translated from the section 987 QBU's old functional currency into the owner's functional currency using the spot rate on the last day of the last taxable year ending before the year of change.

(iii) *QBU and the taxpayer had the same functional currency prior to the change*. If a QBU that has the same functional currency as a taxpayer changes its functional currency to a new functional currency that is different than the functional currency of the taxpayer, and as a result the taxpayer becomes an owner of a section 987 QBU (see § 1.987–1), the taxpayer and section 987 QBU will become subject to section 987 for the year of change and subsequent years.

(2) *QBU changing to the owner's functional currency*. If a section 987 QBU changes its functional currency to the functional currency of its owner, the section 987 QBU shall be treated as if it terminated on the last day of the last taxable year ending before the year of change. See §§ 1.987–5 and 1.987–8 for the effect of a termination of a section 987 QBU that is subject to §§ 1.987–1 through 1.987–11.

(e) *Step 3B—Additional adjustments that are necessary when a taxpayer/owner changes functional currency*—(1) *Corporations*. The amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency paid-in capital shall equal the old functional currency amounts of such items multiplied by the spot rate for translating an amount denominated in the corporation's old functional currency into the corporation's new functional currency on the last day of the last taxable year ending before the year of change. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the new functional currency at the spot rate.

(2) *Collateral consequences to a United States shareholder of a corporation changing to the United States dollar as its functional currency*. A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(A)) of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B)) changing its functional currency to the dollar shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change.

(3) *Taxpayers that are not corporations*. [Reserved].

(4) *Adjustments to a section 987 QBU's balance sheet and net accumulated unrecognized section 987 gain or loss when an owner changes functional currency*—(i) *Owner changing to a functional currency other than the section 987 QBU's functional currency*. If an owner of a section 987 QBU, subject to §§ 1.987–1 through 1.987–11 pursuant to § 1.987–1(b)(1), changes to a functional currency other than the functional currency of the section 987 QBU, the adjustments described in paragraphs (e)(4)(i)(A) through (C) of this section shall be taken into account for purposes of section 987.

(A) *Determining new historic rates*. The historic rate (as defined in § 1.987–1(c)(3)) for the year of change and subsequent taxable years with respect to a historic item (as defined in § 1.987–1(e)) reflected on the balance sheet of the section 987 QBU immediately prior to the year of change shall be equal to the historic rate prior to the year of change (that is, a rate that translates the section 987 QBU's functional currency into the owner's old functional currency) divided by the spot rate for translating an amount denominated in the owner's new functional currency into the owner's old functional currency on the last day of the last taxable year ending before the year of change. For example, if a taxpayer that owns a section 987 QBU with a British pound functional currency changes from a U.S. dollar functional currency to a euro functional currency, and the historic rate for translating a specific item of the section 987 QBU from GBP to USD is 1.50 and the spot rate for translating EUR to USD on the last day of the last taxable year before the change is 1.10, then the new historic rate for translating this historic item from GBP to EUR is 1.36 (1.50/1.10).

(B) *Determining the owner functional currency net value of the section 987 QBU on the last day of the last taxable year ending before the year of change under § 1.987–4(d)(1)(i)(B)*. For purposes of determining the change in the owner functional currency net value of the section 987 QBU on the last day of the last taxable year preceding the year of change under §§ 1.987–4(d)(1)(i)(B) and 1.987–4(e), the section 987 QBU's marked items shall be translated into the owner's new functional currency at the spot rate on the last day of the last taxable year ending before the year of change.

(C) *Translation of net accumulated unrecognized section 987 gain or loss*. Any net accumulated unrecognized section 987 gain or loss determined under § 1.987–4 shall be translated from the owner's old functional currency into the owner's new functional currency using the spot rate for translating an amount denominated in the owner's old functional currency into the owner's new functional currency on the last day of the last taxable year ending before the year of change.

(ii) *Taxpayer with the same functional currency as its QBU changing to a different functional currency*. If a taxpayer with the same functional currency as its QBU changes to a new functional currency and as a result the taxpayer becomes an owner of a section 987 QBU (see § 1.987–1), the taxpayer and the section 987 QBU shall become subject to section 987 for the year of change and subsequent years.

(iii) *Owner changing to the same functional currency as the section 987 QBU*. If an owner changes its functional currency to the functional currency of its section 987 QBU, the section 987 QBU shall be treated as if it terminated on the last day of the last taxable year ending before the year of change. See §§ 1.987–5 and 1.987–8 for the consequences of a termination of a section 987 QBU that is subject to §§ 1.987–1 through 1.987–11.

(f) *Example*. The provisions of this section are illustrated by the following example:

Example. (i) *Facts*. FC, a foreign corporation, owns all of the stock of DC, a domestic corporation. The Commissioner granted permission to change FC's functional currency from the British pound to the euro beginning January 1, 2020. The EUR/GBP exchange rate on December 31, 2019, is €1:£0.50.

(ii) *Determining new functional currency basis of property and liabilities*. The following table shows how FC must convert the items on its balance sheet from the British pound to the euro on December 31, 2019.

	GBP	EUR
Assets:		
Cash on hand	£40,000	€80,000
Accounts Receivable	£10,000	€20,000
Inventory	£100,000	€200,000
€100,000 Euro Bond (£100,000 historical basis)	£50,000	€100,000
Fixed assets:		
Property	£200,000	€400,000
Plant	£500,000	€1,000,000
Accumulated Depreciation	(£200,000)	(€400,000)
Equipment	£1,000,000	€2,000,000
Accumulated Depreciation	(£400,000)	(€800,000)
Total Assets	£1,300,000	€2,600,000
Liabilities:		
Accounts Payable	£50,000	€100,000
Long-term Liabilities	£400,000	€800,000
Paid-in-Capital	£800,000	€1,600,000
Retained Earnings	£50,000	€100,000
Total Liabilities and Equity	£1,300,000	€2,600,000

(iii) *Exchange gain or loss on section 988 transactions*. Under paragraph (b) of this section, FC will recognize a £50,000 loss (£50,000 current value minus £100,000 historical basis) on the Euro Bond resulting from the change in functional currency because, after the change, the Euro Bond will no longer be an asset denominated in a non-functional currency. The amount of FC's retained earnings on its December 31, 2019, balance sheet reflects the £50,000 loss on the Euro Bond.

(g) *Effective/applicability date*. Generally, this regulation shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

Par. 4. Section 1.987–0 is added and §§ 1.987–1 through 1.987–5 are revised to read as follows:

* * * * *

Sec.

1.987–0 Section 987; Table of contents.
1.987–1 Scope, definitions and special rules.
1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.
1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.
1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.
1.987–5 Recognition of section 987 gain or loss.

* * * * *

§ 1.987–0 Section 987; table of contents.

This section lists captioned paragraphs contained in §§ 1.987–1 through 1.987–11.

§ 1.987–1 Scope, definitions and special rules.

§ 1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

aggregate partnership or DE that are not attributed to an eligible QBU.
(c) Transfers to and from section 987 QBUs.
(1) In general.
(2) Disregarded transactions.
(3) Transfers of assets to and from section 987 QBUs owned through section 987 aggregate partnerships.
(4) Transfers of liabilities to and from section 987 QBUs owned through section 987 aggregate partnerships.
(5) Acquisitions and dispositions of interests in DEs and section 987 aggregate partnerships.
(6) Changes in form of ownership.
(7) Application of general tax law principles.
(8) Interaction with § 1.988–1(a)(10).
(9) [Reserved].
(10) Examples.
(d) Translation of items transferred to a section 987 QBU.
(1) Marked items.
(2) Historic items.

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

(a) In general.
(b) Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency.
(1) In general.
(2) Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency.
(3) Determination in the case of a section 987 QBU owned through a section 987 aggregate partnership.
(4) [Reserved].
(c) Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency.
(1) In general.
(2) Exceptions.
(3) Adjustments to COGS required under the simplified inventory method.
(d) [Reserved].
(e) Examples.

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

(a) In general.
(b) Calculation of net unrecognized section 987 gain or loss.
(c) Net accumulated unrecognized section 987 gain or loss for all prior taxable years.
(1) In general.
(2) [Reserved].
(d) Calculation of unrecognized section 987 gain or loss for a taxable year.
(1) Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year.
(2) Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner.
(3) Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU.
(4) Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner.
(5) Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU.
(6) Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.
(7) Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.
(8) Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any tax-exempt income.
(e) Determination of the owner functional currency net value of a section 987 QBU.
(1) In general.
(2) Translation of balance sheet items into the owner's functional currency.
(f) [Reserved].
(g) Examples.

§ 1.987–5 Recognition of section 987 gain or loss.

(a) Recognition of section 987 gain or loss by the owner of a section 987 QBU.
(b) Remittance proportion.
(c) Remittance.
(1) Definition.
(2) Day when a remittance is determined.
(3) Termination.
(d) Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year.
(e) Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year.
(f) Determination of owner's adjusted basis in transferred assets.
(1) In general.
(2) Marked asset.
(3) Historic asset.
(g) Example.

§ 1.987–6 Character and source of section 987 gain or loss.

(a) Ordinary income or loss.
(b) Character and source of section 987 gain or loss.
(1) In general.
(2) Method required to characterize and source section 987 gain or loss.
(3) Coordination with section 954.
(c) Examples.

§ 1.987–7 Section 987 aggregate partnerships.

(a) In general.
(b) [Reserved].
(c) Coordination with subchapter K.

§ 1.987–8 Termination of a section 987 QBU.

(a) Scope.
(b) In general.
(1) Trade or business ceases.
(2) Substantially all assets transferred.
(3) Owner no longer a CFC.
(4) Owner ceases to exist.
(c) Transactions described in section 381(a).
(1) Liquidations.
(2) Reorganizations.
(d) [Reserved].
(e) Effect of terminations.
(f) Examples.

§ 1.987–9 Recordkeeping requirements.

(a) In general.
(b) Supplemental information.
(c) Retention of records.
(d) Information on a dedicated section 987 form.

§ 1.987–10 Transition rules.

(a) Scope.
(b) Fresh start transition method.
(1) In general.
(2) Application of § 1.987–4.
(3) Determination of historic rate.
(4) Example.
(c) Transition of section 987 QBUs that applied the method set forth in the 2006 proposed section 987 regulations.
(1) In general.
(2) Application of § 1.987–4.
(3) Use of prior historic rate.
(4) Example.
(d) Adjustments to avoid double counting.
(e) Reporting.
(1) In general.
(2) Attachments not required where information is reported on a form.

§ 1.987–11 Effective/applicability date.

(a) In general.
(b) Application of these regulations to taxable years beginning after December 7, 2016.
(c) Transition date.

§ 1.987–1 Scope, definitions, and special rules.

(a) *In general*. These regulations under section 987 (§§ 1.987–1 through 1.987–11) provide rules for determining the taxable income or loss of a taxpayer with respect to a section 987 QBU (as defined in paragraph (b)(2) of this section). Further, these regulations provide rules for determining the timing, amount, character, and source of section 987 gain or loss recognized with respect to a section 987 QBU. This section addresses the scope of these regulations and provides certain definitions, special rules, and the procedures for making the elections provided for in the regulations. Section 1.987–2 provides rules for attributing assets and liabilities and items of income, gain, deduction, and loss to an eligible QBU. It also provides rules regarding the translation of items transferred to a section 987 QBU. Section 1.987–3 provides rules for determining and translating the taxable income or loss of a taxpayer with respect to a section 987 QBU. Section 1.987–4 provides rules for determining net unrecognized section 987 gain or loss. Section 1.987–5 provides rules regarding the recognition of section 987 gain or loss. It also provides rules for determining an owner's basis in assets transferred from a section 987 QBU. Section 1.987–6 provides rules regarding the character and source of section 987 gain or loss. Section 1.987–7 provides rules with respect to section 987 aggregate partnerships. Section 1.987–8 provides rules regarding the termination of a section 987 QBU. Section 1.987–9 provides rules regarding the recordkeeping required under section 987. Section 1.987–10 provides transition rules. Section 1.987–11 provides the effective/applicability date of these regulations.

(b) *Scope of section 987 and definitions*—(1) *Taxpayers subject to section 987*—(i) *In general*. Except as provided in paragraphs (b)(1)(ii) and (b)(6) of this section, an individual or corporation is subject to these regulations under section 987 if such person is an owner (as defined in paragraph (b)(4) of this section) of an eligible QBU (as defined in paragraph (b)(3) of this section) that is a section 987 QBU (as defined in paragraph (b)(2) of this section).

(ii) *Inapplicability to certain entities*. Except as otherwise provided in paragraph (b)(1)(iii) of this section, these regulations under section 987 do not apply to specified entities described in this paragraph (b)(1)(ii), other than specified entities that engage in transactions primarily with related persons within the meaning of section 267(b) or section 707(b) that are not themselves specified entities. For this purpose, specified entities means banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, or real estate investment trusts. Further, except as otherwise provided in paragraph (b)(1)(iii) of this section, these regulations do not apply to trusts, estates, S corporations, and partnerships other than section 987 aggregate partnerships (as defined in paragraph (b)(5) of this section).

(iii) [Reserved].

(2) *Definition of a section 987 QBU*—(i) *In general*. A section 987 QBU is an eligible QBU (as defined in paragraph (b)(3) of this section) that has a functional currency different from its direct owner. A section 987 QBU also includes the assets and liabilities of an eligible QBU that are considered under paragraph (b)(5)(ii) of this section to be a section 987 QBU of a partner in a section 987 aggregate partnership (as defined in paragraph (b)(5) of this section). A section 987 QBU will continue to be treated as a section 987 QBU of the owner until a sale or other termination of the section 987 QBU as described in § 1.987–8(b). Except as provided in paragraph (b)(2)(ii) of this section, the functional currency of an eligible QBU shall be determined under § 1.985–1.

(ii) *Section 987 QBU grouping election*—(A) *In general*. Except as provided in paragraph (b)(2)(ii)(B) of this section, an owner may elect to treat, solely for purposes of section 987, all section 987 QBUs with the same functional currency that it directly owns as a single section 987 QBU.

(B) *Special grouping rules for section 987 QBUs owned indirectly through a section 987 aggregate partnership*. An owner may elect to treat all section 987 QBUs with the same functional currency owned indirectly through a single section 987 aggregate partnership (as defined in paragraph (b)(5) of this section) as a single section 987 QBU. An owner may not treat section 987 QBUs as a single section 987 QBU if such QBUs are owned indirectly through different section 987 aggregate partnerships. Additionally, an owner may not treat section 987 QBUs that are owned both directly and indirectly through a section 987 aggregate partnership as a single section 987 QBU.

(3) *Definition of an eligible QBU*—(i) *In general*. Eligible QBU means a qualified business unit, as defined in § 1.989(a)–1, that is not subject to the Dollar Approximate Separate Transactions Method rules of § 1.985–3.

(ii) *Exclusion of certain entities*. A corporation, partnership, trust, estate, or entity disregarded as an entity separate from its owner for Federal income tax purposes as described in § 301.7701–2(c)(2) (hereafter referred to as a "DE") is not an eligible QBU (even though such an entity may have activities that qualify as an eligible QBU).

(4) *Definition of owner*. For purposes of these regulations under section 987, an owner is any person having direct or indirect ownership in an eligible QBU. Only

an individual or corporation may be an owner of an eligible QBU. The term *owner* for section 987 purposes does not include an eligible QBU. For example, a section 987 QBU (QBU1) is not an owner of another section 987 QBU (QBU2) even if QBU1 owns the stock of QBU2.

(i) *Direct ownership.* An individual or a corporation is a direct owner of an eligible QBU if the individual or corporation is the owner for Federal income tax purposes of the assets and liabilities of the eligible QBU.

(ii) *Indirect ownership*. An individual or corporation that is a partner in a section 987 aggregate partnership (as defined in paragraph (b)(5) of this section) and is allocated, under § 1.987–7, all or a portion of the assets and liabilities of an eligible QBU of such partnership is an indirect owner of the eligible QBU.

(5) *Section 987 aggregate partnership*—(i) *In general*. A partnership is a section 987 aggregate partnership if:

(A) 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). For purposes of this paragraph (b)(5), ownership of an interest in partnership capital or profits is determined in accordance with the rules for constructive ownership provided in section 267(c), other than section 267(c)(3); and

(B) The partnership has one or more eligible 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.

(ii) *Section 987 QBU of a partner*. The assets and liabilities of an eligible QBU owned through a section 987 aggregate partnership and allocated to a partner under the principles of § 1.987–7(b) are considered to be a section 987 QBU of such partner if the partner has a functional currency different from that of the eligible QBU.

(iii) *Certain unrelated partners disregarded*. In determining whether a partnership is a section 987 aggregate partnership, the interest of an unrelated partner shall be disregarded if the acquisition of such interest has as a principal purpose the avoidance of this paragraph (b)(5).

(6) [Reserved].

(7) *Examples illustrating paragraph (b) of this section*. The following examples illustrate the principles of paragraph (b) of this section. U.S. Corp is a domestic corporation, has the U.S. dollar as its functional currency, and uses the calendar year as its taxable year. Except as otherwise provided, (i) Business A and Business B are eligible QBUs and have the euro and the Japanese yen, respectively, as their functional currencies and (ii) DE1 and DE2 are DEs, have no assets or liabilities, and conduct no activities.

Example 1. (i) *Facts*. U.S. Corp owns Business A and all of the interests in DE1. DE1 maintains a separate set of books and records that are kept in British pounds. DE1 owns pounds and all of the stock of a foreign corporation, FC. DE1 is liable to a lender on a pound-denominated obligation that was incurred to acquire the stock of FC. The FC stock, the pounds, and the liability incurred to acquire the FC stock are recorded on DE1's separate books and records. DE1 has no other assets or liabilities and conducts no activities (other than holding the FC stock and servicing its liability).

(ii) *Analysis*. (A) Pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of Business A because it is the owner of the assets and liabilities of Business A. Because Business A is an eligible QBU with a functional currency that is different from the functional currency of its owner, U.S. Corp, Business A is a section 987 QBU (as defined in paragraph (b)(2) of this section). As a result, U.S. Corp and its section 987 QBU, Business A, are subject to section 987.

(B) Holding the stock of FC and pounds and servicing a liability does not constitute a trade or business within the meaning of § 1.989(a)–1(c). Because the activities of DE1 do not constitute a trade or business within the meaning of § 1.989(a)–1(c), such activities are not an eligible QBU. In addition, pursuant to paragraph (b)(3)(ii) of this section, DE1 itself is not an eligible QBU. As a result, neither DE1 nor its activities qualify as a section 987 QBU of U.S. Corp. Therefore, neither the activities of DE1 nor DE1 itself is subject to section 987. For the foreign currency treatment of payments on DE1's pound-denominated liability, see § 1.988–2(b).

Example 2. (i) *Facts*. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. The only activities of DE1 are Business A activities and holding the interests in DE2. DE2 owns Business B and Business C. For purposes of this example, Business B does not maintain books and records that are separate from its owner, DE2. Instead, the activities of Business B are reflected on the books and records of DE2, which are maintained in Japanese yen. In addition, Business C has the U.S. dollar as its functional currency, maintains books and records that are separate from the books and records of DE2, and is an eligible QBU.

(ii) *Analysis*. (A) Pursuant to paragraph (b)(3)(ii) of this section, DE1 and DE2 are not eligible QBUs. Pursuant to paragraph (b)(3)(i) of this section, the Business B and Business C activities of DE2, and the Business A activities of DE1, are eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, DE1 is not the owner of the Business A, Business B, or Business C eligible QBUs, and DE2 is not the owner of the Business B or Business C eligible QBUs. Instead, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of the Business A, Business B, and Business C eligible QBUs.

(B) Because Business A and Business B are eligible QBUs with functional currencies that are different than the functional currency of U.S. Corp, Business A and Business B are section 987 QBUs (as defined in paragraph (b)(2) of this section).

(C) The Business C eligible QBU has the same functional currency as U.S. Corp. Therefore, the Business C eligible QBU is not a section 987 QBU.

Example 3. (i) *Facts*. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and Business B. For purposes of this example, assume Business B has the euro as its functional currency.

(ii) *Analysis*. (A) Pursuant to paragraph (b)(3)(ii) of this section, DE1 is not an eligible QBU. Moreover, pursuant to paragraph (b)(4) of this section, DE1 is not the owner of the Business A or Business B eligible QBUs. Instead, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp is the direct owner of the Business A and Business B eligible QBUs.

(B) Business A and Business B constitute two separate eligible QBUs, each with the euro as its functional currency. Accordingly, Business A and Business B are section 987 QBUs of U.S. Corp. U.S. Corp may elect to treat Business A and Business B as a single section 987 QBU pursuant to paragraph (b)(2)(ii)(A) of this section. If such election is made, pursuant to paragraph (b)(4)(i) of this section, U.S. Corp would be the direct owner of the Business AB section 987 QBU that would include the activities of both the Business A section 987 QBU and the Business B section 987 QBU. In addition, pursuant to paragraph (b)(4) of this section, DE1 would not be treated as the owner of the Business AB section 987 QBU.

Example 4. (i) *Facts*. U.S. Corp owns all the stock of Y, a U.S. corporation that is a member of U.S. Corp's consolidated group. U.S. Corp also owns all the stock of CFC, a controlled foreign corporation (as defined in section 957(a)) of U.S. Corp with the Japanese yen as its functional currency. Y and CFC are the only partners in P, a foreign partnership. P owns DE1 and Business A. DE1 owns Business B.

(ii) *Analysis*. (A) Under paragraph (b)(5)(i) of this section, P is a section 987 aggregate partnership because Y and CFC own all the interests in partnership capital and profits, Y and CFC are related within the meaning of section 267(b), and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Pursuant to paragraph (b)(3)(ii) of this section, P and DE1 are not eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, for purposes of section 987, neither P nor DE1 is the owner of the Business B eligible QBU, and P is not the owner of the Business A eligible QBU. Instead, pursuant to paragraph (b)(4)(ii) of this section, Y and CFC are indirect owners of the Business A eligible QBU and the Business B eligible QBU to the extent they are allocated the assets and liabilities of such businesses under § 1.987–7.

(B) Because Business A and Business B are eligible QBUs with different functional currencies than Y, the portions of Business A and Business B allocated to Y under § 1.987–7 are section 987 QBUs of Y.

(C) Because the Business A eligible QBU has a different functional currency than CFC, the portion of Business A that is allocated to CFC under § 1.987–7 is a section 987 QBU, and CFC and its section 987 QBU are subject to section 987. Because the Business B eligible QBU has the same functional currency as CFC, the portion of Business B that is allocated to CFC under § 1.987–7 is not a section 987 QBU of CFC.

Example 5. (i) *Facts*. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. DE2 owns Business B and all of the interests in DE3, an entity disregarded as an entity separate from its owner. DE3 owns Business C, which is an eligible QBU with the Russian ruble as its functional currency.

(ii) *Analysis*. Pursuant to paragraph (b)(3)(ii) of this section, DE1, DE2, and DE3 are not eligible QBUs, and the Business A, Business B, and Business C activities are eligible QBUs. Pursuant to paragraph (b)(4) of this section, an eligible QBU is not an owner of another eligible QBU. Accordingly, the Business A eligible QBU is not the owner of the Business B eligible QBU, and the Business B eligible QBU is not the owner of the Business C eligible QBU. Instead, pursuant to paragraph (b)(4) of this section, U.S. Corp is the direct owner of the Business A, Business B, and Business C eligible QBUs. Because each of the Business A, Business B, and Business C eligible QBUs has a different functional currency than U.S. Corp, such eligible QBUs are section 987 QBUs of U.S. Corp.

(c) *Exchange rates*. Solely for purposes of section 987, the following definitions shall apply.

(1) *Spot rate*—(i) *In general*. Except as otherwise provided in this section, the spot rate means the rate determined under the principles of § 1.988–1(d)(1), (2), and (4) on the relevant date.

(ii) *Election to use a spot rate convention*—(A) *In general—spot rate convention*. An owner may elect to use a spot rate convention that reasonably approximates the spot rate determined in paragraph (c)(1)(i) of this section in lieu of such spot rate. A spot rate convention may be determined with respect to a spot rate at the beginning of a reasonable period, the end of a reasonable period, as an average of spot rates for a reasonable period, or by reference to spot and forward rates for a reasonable period. For this purpose, a reasonable period shall not exceed three months. For example, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate for all transactions during a monthly period can be determined pursuant to one of the following conventions: the spot rate at the beginning of the current month or at the end of the preceding month; the monthly average of daily spot rates for the current or preceding month; or an average of the beginning and ending spot rates for the current or preceding month. Similarly, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate can be determined pursuant to an average of the spot rate and the 30-day forward rate on a day of the preceding month. Use of a spot rate convention that is consistent with the convention used for financial accounting purposes is presumed to reasonably approximate the rate in paragraph (c)(1)(i) of this section. The Commissioner can rebut this presumption if the Commissioner determines that the use of the convention would not clearly reflect income based on the facts and circumstances available at the time of the election.

(B) [Reserved].

(iii) *Election to use spot rates in lieu of yearly average exchange rates*. A taxpayer may elect under this paragraph (c)(1)(iii) to use spot rates in lieu of yearly average exchange rates (as defined in paragraph (c)(2) of this section) for certain purposes. In particular, a taxpayer that makes this election must use the spot rate for purposes of determining the historic rate, as provided in paragraph (c)(3)(ii) of this section, and for purposes of translating items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency, as described in § 1.987–3(c)(1). Additionally, a taxpayer that makes this election will be deemed also to elect to use the historic inventory method described in § 1.987–3(c)(2)(iv)(B).

(2) *Yearly average exchange rate*. For purposes of section 987, the yearly average exchange rate is a rate that represents an average exchange rate for the taxable year (or, if the relevant period is less than a full taxable year, such portion of the taxable year) computed under any reasonable method. For example, an owner may determine the yearly average exchange rate based on a daily, monthly or quarterly averaging convention, whether weighted or unweighted, and may take into account forward rates for a period not to exceed three months. Use of an averaging convention that is consistent with the convention used for financial accounting purposes is presumed to be a reasonable method. The Commissioner can rebut this presumption if the Commissioner determines that the use of the convention would not have been expected to clearly reflect income based on the facts and circumstances available at the time of the election.

(3) *Historic rate*—(i) *In general*. Except as otherwise provided in these regulations, the historic rate is determined as described in paragraphs (c)(3)(i)(A) through (E) of this section.

(A) *Assets generally*. In the case of an asset other than inventory that is acquired by a section 987 QBU (including through a transfer), the historic rate is the yearly average exchange rate applicable to the year of acquisition.

(B) *Inventory under the simplified inventory method*. In the case of inventory with respect to which a taxpayer uses the simplified inventory method described in § 1.987–3(c)(2)(iv)(A), the historic rate for inventory accounted for under the last-in, first-out (LIFO) method of accounting is the yearly average exchange rate applicable to the year in which the inventory's LIFO layer arose. The historic rate for all other inventory of such a taxpayer is the yearly average exchange rate for the taxable year for which the determination of the historic rate for such inventory is relevant.

(C) *Inventory under the historic inventory method*. In the case of inventory with respect to which a taxpayer has elected under § 1.987– 3(c)(2)(iv)(B) to use the historic inventory method, each inventoriable cost with respect to such inventory may have a different historic rate. The historic rate for each inventoriable cost is the exchange rate at which such item would be translated under § 1.987–3 if it were not an inventoriable cost.

(D) *Liabilities generally*. In the case of a liability that is incurred or assumed by a section 987 QBU, the historic rate is the yearly average exchange rate applicable to the year the liability is incurred or assumed.

(E) [Reserved].

(ii) *Historic rate when an election to use spot rates in lieu of yearly average exchange rates is in effect*. A taxpayer that has elected under paragraph (c)(1)(iii) of this section to use spot rates in lieu of yearly average exchange rates must determine historic rates under paragraphs (c)(3)(i)(A) and (c)(3)(i)(D) of this section using the spot rate (as defined in paragraph (c)(1) of this section) for the date an asset is acquired by a section 987 QBU or a liability is assumed or incurred by a section 987 QBU in lieu of using the yearly average exchange rate.

(iii) *Date placed in service for depreciable or amortizable property*. In the case of depreciable or amortizable property, an owner may determine the historic rate (whether a yearly average exchange rate or a spot rate, as applicable) by reference to the date such property is placed in service by the section 987 QBU rather than the date the property was acquired, provided that this convention is consistently applied for all such property attributable to that section 987 QBU.

(iv) *Changed functional currency*. In the case of a section 987 QBU or an owner of a section 987 QBU that previously changed its functional currency, § 1.985–5(d)(1)(ii)(A) and § 1.985–5(e)(4)(i)(A), respectively, shall be taken into account in determining the historic rate for an item reflected on the balance sheet of the section 987 QBU immediately prior to the year of change.

(d) *Marked item*. A marked item is an asset (marked asset) or liability (marked liability) that is properly reflected on the books and records of a section 987 QBU under § 1.987–2(b) and that—

(1) Is denominated in, or determined by reference to, the functional currency of the section 987 QBU, is not a section 988 transaction of the section 987 QBU, and would be a section 988 transaction if such item were held or entered into directly by the owner of the section 987 QBU;

(2) Is a prepaid expense or a liability for an advance payment of unearned income, in either case having an original term of one year or less on the date the prepaid expense or liability for an advance payment of unearned income arises; or

(3) [Reserved].

(e) *Historic item*. A historic item is an asset (historic asset) or liability (historic liability) that is properly reflected on the books and records of a section 987 QBU under § 1.987–2(b) and that is not a marked item (as defined in paragraph (d) of this section).

(f) [Reserved].

(g) *Elections*—(1) *In general*. This paragraph (g) provides rules for making elections under section 987. Except as otherwise provided in paragraph (g)(2) of this section, such elections—

(i) May be made separately for each section 987 QBU;

(ii) Are made by the owner of the section 987 QBU (as defined in paragraph (b)(4) of this section); and

(iii) Must be made for the first taxable year in which the election is relevant in determining the section 987 taxable income or loss, or section 987 gain or loss, of the section 987 QBU and in which the regulations implementing the election are applicable with respect to the section 987 QBU.

(2) *Exceptions to the general rules*—(i) *Consistency and timeliness requirements for certain elections*. Notwithstanding paragraph (g)(1)(i) of this section, the following consistency and timeliness requirements apply:

(A) *Section 987 grouping election*. Elections made pursuant to paragraph (b)(2)(ii) of this section (regarding the grouping of section 987 QBUs) are binding on all section 987 QBUs that are eligible to be grouped under the particular election (for example, election to group all euro QBUs owned by the same aggregate partnership), regardless of whether the section 987 QBU is established or acquired after the election is made and regardless of whether the section 987 QBU is identified on the election as required in paragraph (g)(3)(i)(A) of this section.

(B) [Reserved].

(ii) *Persons making elections for QBUs owned by foreign corporations*. Notwithstanding paragraph (g)(1)(ii) of this section, if a section 987 QBU is owned by a foreign corporation, elections shall be made in accordance with § 1.964–1(c) by the foreign corporation's controlling domestic shareholders, as defined under § 1.964–1(c)(5)(i) (dealing with controlled foreign corporations) and § 1.964–1(c)(5)(ii) (dealing with noncontrolled section 902 corporations).

(3) *Manner of making elections*—(i) *Election made by attaching statement to a return*. Except as provided in paragraph (g)(3)(ii) of this section, elections shall be made under section 987 for each section 987 QBU by attaching a statement with the information required in this paragraph (g)(3)(i) to the timely filed tax return of the owner or, in the case of a foreign corporation, other applicable person for the first taxable year in which the election is required to be made under paragraph (g)(1)(iii) of this section.

(A) *Section 987 grouping election*. The election provided in paragraph (b)(2)(ii) of this section must be titled "Section 987 Grouping Election Under § 1.987–1(b)(2)(ii)" and provide the following information:

(*1*) The name, address, and functional currency of each section 987 QBU that the taxpayer is grouping together; and

(*2*) The owner's name and address.

(B) *Election to use a spot rate convention*. An election under paragraph (c)(1)(ii) of this section to use a spot rate convention must be titled "Section 987 Election to Use a Spot Rate Convention Under § 1.987–1(c)(1)(ii)" and provide the following information:

(*1*) A description of the convention; and

(*2*) The name and address of each section 987 QBU for which the election is being made.

(C) *Election to use spot rates in lieu of yearly average exchange rates*. An election under paragraph (c)(1)(iii) of this section to use spot rates in lieu of yearly average exchange rates must be titled "Section 987 Election to Use Spot Rates in Lieu of Yearly Average Exchange Rates Under § 1.987–1(c)(1)(iii)" and provide the following information:

(*1*) A description of the convention; and

(*2*) The name and address of each section 987 QBU for which the election is being made.

(D) *Election to use the historic inventory method*. An election under § 1.987–3(c)(2)(iv)(B) to use the historic inventory method shall be titled "Section 987 Election to Use the Historic Inventory Method Under § 1.987–3(c)(2)(iv)(B)" and must provide the name and address of each section 987 QBU for which the election is being made.

(ii) *Election made by filing a dedicated section 987 form*. If the Commissioner publishes a form that provides the manner in which elections are made under section

987, the form shall govern the manner in which elections are made under section 987.

(4) *No change in method of accounting*. An election under section 987 is not governed by the general rules concerning changes in methods of accounting. See also paragraph (g)(5) of this section.

(5) *Revocation of an election.* Elections under section 987 may not be revoked without the consent of the Commissioner or his delegate. The Commissioner or his delegate will consider allowing a revocation of an election if the taxpayer can demonstrate significantly changed circumstances or such other circumstances that clearly demonstrate a substantial nontax business reason for revoking the election.

§ 1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

(a) *Scope and general principles*. Paragraph (b) of this section provides rules for attributing assets and liabilities, and items of income, gain, deduction, and loss, to an eligible QBU. Assets and liabilities are attributed to a section 987 QBU for purposes of section 987. Items of income, gain, deduction, and loss are attributed to a section 987 QBU for purposes of computing the section 987 taxable income of the section 987 QBU and of its owner. Paragraph (c) of this section defines a transfer to or from a section 987 QBU. Paragraph (d) of this section provides translation rules for transfers to a section 987 QBU.

(b) *Attribution of items to an eligible QBU*—(1) *General rules*. Except as provided in paragraphs (b)(2) and (3) of this section, items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records, as defined in § 1.989(a)–1(d), of the eligible QBU. In the case of a section 987 aggregate partnership, items reflected on the books and records of the partnership and deemed allocated to an eligible QBU of such partnership are considered to be reflected on the books and records of such eligible QBU. For purposes of this section, the term "item" refers to any asset or liability, and any item of income, gain, deduction, or loss. Items that are attributed to an eligible QBU pursuant to this section must be adjusted to conform to Federal income tax principles. Except as provided in § 1.989(a)–1(d)(3), these attribution rules apply solely for purposes of section 987. For example, the allocation and apportionment of interest expense under section 864(e) is independent of the rules under section 987.

(2) *Exceptions for non-portfolio stock, interests in partnerships, and certain acquisition indebtedness*. The following items shall not be considered to be on the books and records of an eligible QBU:

(i) Stock of a corporation (whether domestic or foreign), other than stock of a corporation reflected on the books and records (within the meaning of paragraph (b)(1) of this section) of an eligible QBU if the owner of the eligible QBU owns less than 10 percent of the total value of all classes of stock of such corporation. For this purpose, section 318(a) applies in determining ownership, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

(ii) An interest in a partnership (whether domestic or foreign).

(iii) A liability that was incurred to acquire stock described in paragraph (b)(2)(i) of this section or that was incurred to acquire a partnership interest described in paragraph (b)(2)(ii) of this section.

(iv) Income, gain, deduction, or loss arising from the items described in paragraphs (b)(2)(i) through (iii) of this section. For example, a section 951 inclusion with respect to stock of a foreign corporation described in paragraph (b)(2)(i) of this section shall not be considered to be on the books and records of an eligible QBU.

(3) *Adjustments to items reflected on the books and records*—(i) *General rule*. If a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987, the item must be allocated between or among the eligible QBU, the owner of such eligible QBU, and any other persons, entities (including DEs), or other QBUs within the meaning of § 1.989(a)–1(b) (including eligible QBUs) in a manner that reflects the substance of the transaction. For purposes of this paragraph (b)(3)(i), relevant factors for determining whether such Federal income tax avoidance is a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU shall include, but are not limited to, the factors set forth in paragraphs (b)(3)(ii) and (iii) of this section. The presence or absence of any factor or factors is not determinative. Moreover, the weight given to any factor (whether or not set forth in paragraphs (b)(3)(ii) and (iii) of this section) depends on the particular case.

(ii) *Factors indicating no tax avoidance*. For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that recording (or failing to record) an item on the books and records of an eligible QBU did not have as a principal purpose the avoidance of Federal income tax under, or through the use of, section 987 include the recording (or not recording) of an item:

(A) For a significant and bona fide business purpose;

(B) In a manner that is consistent with the economics of the underlying transaction;

(C) In accordance with generally accepted accounting principles (or similar comprehensive accounting standard);

(D) In a manner that is consistent with the treatment of similar items from year to year;

(E) In accordance with accepted conditions or practices in the particular trade or business of the eligible QBU;

(F) In a manner that is consistent with an explanation of existing internal accounting policies that is evidenced by documentation contemporaneous with the timely filing of a Federal income tax return for the taxable year; and

(G) As a result of a transaction between legal entities (for example, the transfer of an asset or the assumption of a liability), even if such transaction is not regarded for Federal income tax purposes (for example, a transaction between a DE and its owner).

(iii) *Factors indicating tax avoidance*. For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987 include:

(A) The presence or absence of an item on the books and records that is the result of one or more transactions that are transitory, for example, due to a circular flow of cash or other property;

(B) The presence or absence of an item on the books and records that is the result of one or more transactions that do not have substance;

(C) The presence or absence of an item on the books and records that results in the taxpayer (or a person related to the taxpayer within the meaning of section 267(b) or section 707(b)) having offsetting positions with respect to the functional currency of a section 987 QBU; and

(D) The absence of any or all of the factors listed in paragraph (b)(3)(ii) of this section.

(4) *Assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU*. Neither a section 987 aggregate partnership nor a DE is an eligible QBU and, thus, neither entity can be a section 987 QBU. See § 1.987–1(b)(2) and (3). As a result, a section 987 aggregate partnership or DE may own assets and liabilities that are not attributed to an eligible QBU as provided under this paragraph (b) and, therefore, are not subject to section 987. For the foreign currency treatment of such assets or liabilities, see § 1.988–1(a)(4).

(c) *Transfers to and from section 987 QBUs*—(1) *In general*. The following rules apply for purposes of determining whether there is a transfer of an asset or a liability from an owner to a section 987 QBU, or from a section 987 QBU to an owner. These rules apply solely for purposes of section 987.

(2) *Disregarded transactions*—(i) *General rule*. An asset or liability shall be treated as transferred to a section 987 QBU from its owner (whether direct owner or indirect owner, as defined in § 1.987–1(b)(4)) if, as a result of a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section), such asset or liability is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section. Similarly, an asset or liability shall be treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, such asset or liability is no longer reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section.

(ii) *Definition of a disregarded transaction*. For purposes of this section, a disregarded transaction means a transaction that is not regarded for Federal income tax purposes (for example, any transaction between separate section 987 QBUs of the same owner). For purposes of this paragraph (c), a disregarded transaction shall be treated as including the recording of an asset or liability on the books and records of an eligible QBU (as defined in § 1.987–1(b)(3)) of an owner, if the recording is the result of such asset or liability being removed from the books and records of a separate eligible QBU of the same owner, whether such separate eligible QBU is owned directly or is owned indirectly through the same entity (including through a DE or a section 987 aggregate partnership). Additionally, if an asset or liability that is attributable to a section 987 QBU within the meaning of paragraph (b) of this section is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is not attributable to the section 987 QBU immediately after the sale or exchange, the sold or exchanged asset or liability that was attributable to the section 987 QBU immediately before the transaction shall be treated as transferred from the section 987 QBU to its direct or indirect owner in a disregarded transaction immediately before the sale or exchange for purposes of section 987 (including for purposes of recognizing section 987 gain or loss under § 1.987–5) and subsequently sold or exchanged by the owner. The preceding sentence shall not apply with respect to an acquisition or disposition of an interest in a section 987 aggregate partnership or in a DE, as described in paragraph (c)(5) of this section.

(iii) *Items derived from disregarded transactions ignored*. For purposes of section 987, disregarded transactions shall not give rise to items of income, gain, deduction, or loss that are taken into account in determining section 987 taxable income or loss under § 1.987–3.

(3) *Transfers of assets to and from section 987 QBUs owned through section 987 aggregate partnerships*—(i) *Contributions to section 987 aggregate partnerships*. Solely for purposes of section 987, an asset shall be treated as transferred by an indirect owner (as defined in § 1.987–1(b)(4)(ii)) to a section 987 QBU of a partner (as defined in § 1.987–1(b)(5)(ii)) to the extent the indirect owner contributes the asset to the section 987 aggregate partnership that carries on the activities of the section 987 QBU, provided that, immediately prior to the contribution, the asset is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section and the asset is reflected on the books and records of the section 987 QBU immediately following such contribution. For purposes of this paragraph (c)(3)(i), deemed contributions of money described under section 752 shall be disregarded. See paragraph (c)(4)(ii) of this section for rules governing the assumption by a partner of liabilities of a section 987 aggregate partnership.

(ii) *Distributions from section 987 aggregate partnerships.* Solely for purposes of section 987, an asset shall be treated as transferred from a section 987 QBU of a partner to its indirect owner to the extent the section 987 aggregate partnership that carries on the activities of the section 987 QBU distributes the asset to the indirect owner, provided that, immediately prior to such distribution, the asset is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the asset is not reflected on the books and records of the section 987 QBU immediately after such distribution. For purposes of this paragraph (c)(3)(ii), deemed distributions of money described under section 752 shall be disregarded. See paragraph (c)(4)(i) of this section for rules governing the assumption by a section 987 aggregate partnership of liabilities of a partner.

(4) *Transfers of liabilities to and from section 987 QBUs owned through section 987 aggregate partnerships*—(i) *Assumptions of partner liabilities*. Solely for purposes of section 987, a liability of the owner of a section 987 aggregate partnership shall be treated as transferred to a section 987 QBU of a partner if, and to the

extent, the section 987 aggregate partnership assumes such liability, provided that, immediately prior to the transfer, the liability is not reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the liability is reflected on the books and records of the section 987 QBU immediately following the transfer.

(ii) *Assumptions of section 987 aggregate partnership liabilities*. Solely for purposes of section 987, a liability of a section 987 aggregate partnership shall be treated as transferred from a section 987 QBU of a partner to its indirect owner if, and to the extent, the indirect owner assumes such liability of the section 987 aggregate partnership, provided that, immediately prior to such assumption, the liability is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section, and the liability is not reflected on the books and records of the section 987 QBU immediately following the transfer.

(5) *Acquisitions and dispositions of interests in DEs and section 987 aggregate partnerships*. Solely for purposes of section 987, an asset or liability shall be treated as transferred to a section 987 QBU from its owner if, as a result of an acquisition (including by contribution) or disposition of an interest in a section 987 aggregate partnership or DE, such asset or liability is reflected on the books and records of the section 987 QBU. Similarly, an asset or liability shall be treated as transferred from a section 987 QBU to its owner if, as a result of an acquisition or disposition of an interest in a section 987 aggregate partnership or DE, the asset or liability is not reflected on the books and records of the section 987 QBU.

(6) *Changes in form of ownership*. For purposes of this paragraph (c), mere changes in the form of ownership of an eligible QBU shall not result in a transfer to or from a section 987 QBU. Instead, the determination of whether a transfer has occurred in such case shall be made under paragraph (c)(5) of this section. For example, a transaction that causes a direct owner of an eligible QBU to become an indirect owner of the eligible QBU shall not, except to the extent provided in paragraph (c)(5) of this section, result in a transfer to or from a section 987 QBU. See, for example, Rev. Rul. 99–5 (1999–1 CB 434), Rev. Rul. 99–6 (1999–1 CB 432), § 601.601(d)(2) of this chapter, and section 708 and the applicable regulations.

(7) *Application of general tax law principles*. General tax law principles, including the circular cash flow, step-transaction, economic substance, and substance-over-form doctrines, apply for purposes of determining whether there is a transfer of an asset or liability under this paragraph (c), including a transfer of an asset or liability pursuant to a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section).

(8) *Interaction with § 1.988–1(a)(10)*. See § 1.988–1(a)(10) for rules regarding the treatment of an intra-taxpayer transfer of a section 988 transaction.

(9) [Reserved].

(10) *Examples*. The following examples illustrate the principles of this paragraph (c). For purposes of the examples, X and Y are domestic corporations, have the U.S. dollar as their functional currency, and use the calendar year as their taxable years. Furthermore, except as otherwise provided, Business A and Business B are eligible QBUs that have the euro and the Japanese yen, respectively, as their functional currencies, and DE1 and DE2 are DEs. For purposes of determining whether any of the transfers in these examples result in remittances, see § 1.987–5.

Example 1. Transfer to a directly owned section 987 QBU. (i) *Facts*. X owns all of the interests in DE1. DE1 owns Business A, which is a section 987 QBU of X. X owns €100 that are not reflected on the books and records of Business A. Business A is in need of additional capital and, as a result, X lends the €100 to DE1 for use in Business A in exchange for a note.

(ii) *Analysis*. (A) The loan from X to DE1 is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). As a result, the DE1 note held by X and the liability of DE1 under the note are not taken into account under this section.

(B) As a result of the disregarded transaction, the €100 is reflected on the books and records of Business A. Therefore, X is treated as transferring €100 to its Business A section 987 QBU for purposes of section 987. This transfer is taken into account in determining the amount of any remittance for the taxable year under § 1.987–5(c). See § 1.988–1(a)(10)(ii) for the application of section 988 to X as a result of the transfer of non-functional currency to its section 987 QBU.

Example 2. Transfer to a directly owned section 987 QBU. (i) *Facts*. X owns Business A and Business B, both of which are section 987 QBUs of X. X owns equipment that is used in Business A and is reflected on the books and records of Business A. Because Business A has excess manufacturing capacity and X intends to expand the manufacturing capacity of Business B, the equipment formerly used in Business A is transferred to Business B for use by Business B. As a result of the transfer, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B.

(ii) *Analysis*. The transfer of the equipment from the books and records of Business A to the books and records of Business B is not regarded for Federal income tax purposes (because it is an interbranch transaction), and therefore it is a disregarded transaction for purposes of this paragraph (c). Therefore, for purposes of section 987, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring the equipment to the Business B section 987 QBU. These transfers are taken into account in determining the amount of any remittance for the taxable year under § 1.987–5(c).

Example 3. Intracompany sale of property between two section 987 QBUs. (i) *Facts*. X owns all of the interests in DE1 and DE2. DE1 and DE2 own Business A and Business B, respectively, both of which are section 987 QBUs of X. DE1 owns equipment that is used in Business A and is reflected on the books and records of Business A. For business reasons, DE1 sells a portion of the equipment used in Business A to DE2 in exchange for a fair market value amount of Japanese yen. The yen used by DE2 to acquire the equipment was generated by Business B and was reflected on Business B's books and records. Following the sale, the yen and the equipment will be used in Business A and Business B, respectively. As a result of such sale, the equipment is removed from the books and records of Business A and is recorded on the books and records of Business B. Similarly, as a result of the sale, the yen is removed from the books and records of Business B and is recorded on the books and records of Business A.

(ii) *Analysis*. (A) The sale of equipment between DE1 and DE2 is a transaction that is not regarded for Federal income tax purposes (because it is an interbranch transaction). Therefore the transaction is a disregarded transaction for purposes of paragraph (c) of this section. As a result, the sale is not taken into account under this section and, pursuant to paragraph (c)(2)(iii) of this section, the sale does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under § 1.987–3. However, the yen and equipment exchanged by DE1 and DE2 in connection with the sale must be taken into account as a disregarded transaction under this paragraph (c).

(B) As a result of the disregarded transaction, the equipment ceases to be reflected on the books and records of Business A and becomes reflected on the books and records of Business B. Therefore, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring such equipment to the Business B section 987 QBU.

(C) Additionally, as a result of the disregarded transaction, the yen currency ceases to be reflected on the books and records of Business B and becomes reflected on the books and records of Business A. Therefore, the Business B section 987 QBU is treated as transferring the yen to X, and X is subsequently treated as transferring such yen from X to the Business A section 987 QBU. The transfers among Business A, Business B and X are taken into account in determining the amount of any remittance for the taxable year under § 1.987–5(c).

Example 4. Sale of property by a section 987 QBU to a corporation that is a member of the consolidated group. (i) *Facts*. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y file a consolidated return. Business A sells property to Y for €100.

(ii) *Analysis*. The sale of property by Business A to Y is not considered a transfer of property to X (and a corresponding transfer from X to Y) under paragraph (c) of this section because the transaction is regarded for Federal income tax purposes. Rather, for purposes of section 987, the transaction is considered to occur between Business A and Y.

Example 5. T*ransactions of a section 987 QBU owned through an aggregate partnership*. (i) *Facts*. (A) X owns all of the stock of Y and a 50 percent interest in the capital and profits of P, a partnership. Y owns the other 50 percent interest in P. P owns 100 percent of the interests in DE1 and DE2. DE1 owns Business A and DE2 owns Business B.

(B) In connection with Business A, DE1 licenses intangible property to both DE2 and X. X enters into the license agreement in a transaction other than in its capacity as a partner of P and, therefore, the license is considered as occurring between P and one who is not a partner within the meaning of section 707(a). X uses the intangible property in its own trade or business in the U.S. DE2 uses the intangible property in Business B. Pursuant to the license agreement, X and DE2 pay a €30 and a €50 royalty, respectively, to DE1.

(ii) *Analysis*. (A) Under § 1.987–1(b)(5)(i), P is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. X and Y each have a 50 percent allocable share of the assets and liabilities of Business A and Business B, as determined under § 1.987–7. Under § 1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to X are a section 987 QBU of X, and the assets and liabilities of Business A allocated to Y are a section 987 QBU of Y. Likewise, the assets and liabilities of Business B allocated to X are a section 987 QBU of X, and the assets and liabilities of Business B allocated to Y are a section 987 QBU of Y.

(B) The license from DE1 to DE2 is not regarded for Federal income tax purposes (because it is an interbranch agreement) and, as a result, royalty payments under the license are disregarded transactions. Thus, pursuant to paragraph (c)(2)(iii) of this section, DE1's receipt of the royalty pursuant to the license agreement does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under § 1.987–3. However, the €50 that is paid from DE2 to DE1 pursuant to the license agreement must be taken into account under paragraph (c) of this section. Accordingly, €50 ceases to be reflected on the books and records of Business B and becomes reflected on the books and records of Business A. As a result, a 50 percent allocable share of the €50 royalty payment (€25) is treated as transferred from each of the Business B section 987 QBUs of X and Y, to X and Y, respectively. And subsequently, X and Y are treated as transferring their respective receipts of €25 to their respective Business A section 987 QBUs. These transfers are taken into account in determining the amount of any remittance to either of X or Y for the taxable year under § 1.987–5(c).

(C) The €30 royalty payment from X to DE1 is regarded for Federal income tax purposes (because it is a payment from a partnership to a separate entity). Accordingly, the royalty payment is not a disregarded transaction for purposes of this paragraph (c) and is therefore not treated as a transfer of an asset from an owner to a section 987 QBU. As a result, the payment is not taken into account in determining the amount of any remittance for the taxable year under § 1.987–5(c). Instead, the payment gives rise to an item of income and deduction that must be taken into account in computing section 987 taxable income or loss of Business A pursuant to § 1.987–3.

Example 6. Acquisition of an interest in a partnership. (i) *Facts*. (A) X owns all of the stock of Z, a domestic corporation with the dollar as its functional currency. X also owns all of the stock of Y and a 50 percent interest in the capital and profits of P, a partnership. Y owns the other 50 percent interest in P. P owns Business A, and P owns no other assets or liabilities other than those of Business A.

(B) Z contributes cash to P in exchange for a 20 percent interest in the capital and profits of P. The cash Z contributes to P is used in Business A and is reflected on Business A's books and records.

(ii) *Analysis*. (A) Under § 1.987–1(b)(5)(i), P is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Prior to the contribution to P by Z, X and Y each have a 50 percent allocable share of the assets and liabilities of Business A, as determined under § 1.987–7. Under § 1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to X are a section 987 QBU of X, and the assets and liabilities of Business A allocated to Y are a section 987 QBU of Y.

(B) Following Z's acquisition of a 20 percent interest in P, P remains a section 987 aggregate partnership because X, Y and Z own all the interests in partnership capital and profits; X, Y, and Z are related within the meaning of section 267(b); and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Z acquires a 20 percent allocable share of the assets and liabilities of Business A, as determined under § 1.987–7. Under § 1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to Z are a section 987 QBU of Z (because Z becomes an indirect owner of Business A and Z and Business A have different functional currencies).

(C) As a result of Z's contribution of cash to Business A, through its contribution to P, each of X, Y, and Z are allocated a share of that Business A asset. Accordingly, under § 1.987–2(c)(5), Z is treated as contributing its allocable share of the cash to its Business A section 987 QBU. In addition, Z is treated as transferring X's and Y's respective allocable shares of the cash to X and Y, and X and Y are subsequently treated as transferring that cash to their respective Business A section 987 QBUs.

(D) In addition, as a result of Z's acquisition of its interest in P and Z's consequent acquisition of a Business A section 987 QBU, Z's allocable portion of the assets and liabilities of Business A (other than the cash) cease being reflected on the books and records of the respective Business A section 987 QBUs of each of X and Y. Those allocable portions of assets and liabilities from the Business A section 987 QBUs of X and Y are treated as if they are transferred from such section 987 QBUs to their respective owners, X and Y. These assets and liabilities are consequently recorded on the books and records of Z's Business A section 987 QBU. Accordingly, X and Y are treated as transferring those assets and liabilities to Z, and Z is treated as contributing those assets and liabilities to its new Business A section 987 QBU.

Example 7. Acquisition of an interest in a partnership. (i) *Facts*. The facts are the same as in *Example 6*, except that the cash that Z contributes to P in exchange for a 20 percent interest in P is not used in Business A and is not reflected on Business A's books and records. Instead, the cash is reflected on P's books and records.

(ii) *Analysis*. (A) Following Z's acquisition of a 20 percent interest in P, P remains a section 987 aggregate partnership because X, Y and Z own all the interests in partnership capital and profits; X, Y, and Z are related within the meaning of section 267(b); and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Z acquires a 20 percent allocable share of the assets and liabilities of Business A, as determined under § 1.987–7. Under § 1.987–1(b)(5)(ii), the assets and liabilities of Business A allocated to Z are a section 987 QBU of Z (because Z becomes an indirect owner of Business A and Z and Business A have different functional currencies).

(B) As a result of Z's acquisition of its interest in P and Z's consequent acquisition of a Business A section 987 QBU, Z's allocable portion of the assets and liabilities of Business A cease being reflected on the books and records of the respective Business A section 987 QBUs of each of X and Y. Those allocable portions of assets and liabilities from the Business A section 987 QBUs of X and Y are treated as if they are transferred from such section 987 QBUs to their respective owners, X and Y. These assets and liabilities are consequently recorded on the books and records of Z's Business A section 987 QBU. Accordingly, X and Y are treated as transferring those assets and liabilities to Z, and Z is treated as contributing those assets and liabilities to its new Business A section 987 QBU.

Example 8. Conversion of a DE to a partnership through a sale of an interest. (i) *Facts*. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. Y acquires 50 percent of the DE1 interests from X for cash.

(ii) *Analysis*. (A) DE1 is converted to a partnership when Y purchases the 50 percent interest in DE1. For Federal income tax purposes, Y's purchase of 50 percent of X's interest in DE1 is treated as the direct purchase of 50 percent of the assets of Business A because DE1 is disregarded and Business A is treated as held directly by X. Immediately after the sale of 50 percent of Business A to Y, X and Y are treated as contributing their respective interests in the assets of Business A to a partnership. See Rev. Rul. 99–5 (1999–1 CB 434) (situation 1) and § 601.601(d)(2) of this chapter.

(B) For purposes of this paragraph (c), these deemed transactions are disregarded transactions. Under § 1.987–1(b)(5)(i), the newly formed partnership is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Because Y is a partner in a section 987 aggregate partnership that owns Business A and because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU of Y.

(C) As a result of the conversion of DE1 to a partnership, Y acquires an allocable share of 50 percent of the assets and liabilities of Business A, as determined under § 1.987–7. Accordingly, 50 percent of the assets and liabilities of Business A cease being reflected on the books and records of X's section 987 QBU. Under § 1.987–2(b)(5), these amounts are treated as if they are transferred from X's section 987 QBU to X, and X is treated as transferring these assets and liabilities to Y. Accordingly, the assets and liabilities of Business A allocated to Y are treated as transferred by Y to Y's newly formed Business A section 987 QBU.

Example 9. *Conversion of a DE to a partnership through a contribution*. (i) *Facts*. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. Y contributes property (that is not then attributed to a section 987 QBU of Y) to DE1 in exchange for an interest in DE1. The property transferred by Y to DE1 is used in Business A and is reflected on the books and records of Business A.

(ii) *Analysis*. (A) DE1 is converted to a partnership when Y contributes property to DE1 in exchange for a 50 percent interest in DE1. For Federal income tax purposes, Y's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. X is treated as contributing all of Business A to the partnership in exchange for a partnership interest. See Rev. Rul. 99–5 (situation 2), (1999–1 CB 434) and § 601.601(d)(2) of this chapter.

(B) For purposes of this paragraph (c), these deemed transactions are disregarded transactions. Under § 1.987–1(b)(5)(i), the newly formed partnership is a section 987 aggregate partnership because X and Y own all the interests in partnership capital and profits, X and Y are related within the meaning of section 267(b), and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Because Y is a partner in a section 987 aggregate partnership that owns Business A and because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU of Y.

(C) As a result of the conversion of DE1 to a partnership, Y acquires an allocable share of 50 percent of the assets and liabilities of Business A, as determined under § 1.987–7. Accordingly, under § 1.987–2(c)(5), Y is treated as contributing its allocable share of its contributed property to its Business A section 987 QBU. In addition, Y is treated as transferring X's allocable share of the contributed property to X, and X is subsequently treated as transferring that property to its Business A section 987 QBUs. In addition, Y's allocable share of the original (pre-conversion) assets and liabilities of Business A cease being reflected on the books and records of X's section 987 QBU. Under § 1.987–2(b)(5), these amounts are treated as if they are transferred from X's section 987 QBU to X, and X is treated as transferring these assets and liabilities to Y. Y is subsequently treated as transferring these assets and liabilities to Y's Business A section 987 QBU.

Example 10. *Contribution of assets to a corporation*. (i) *Facts*. X owns Business A. X forms Z, a domestic corporation, contributing 50 percent of its Business A assets and liabilities to Z in exchange for all of the stock of Z. X and Z do not file a consolidated tax return.

(ii) *Analysis*. Pursuant to paragraph (b)(2) of this section, the Z stock received in exchange for 50 percent of Business A's assets and liabilities is not reflected on the books and records of, and therefore is not attributable to, Business A for purposes of section 987 immediately after the exchange. As a result, pursuant to paragraph (c)(2)(i) and (ii) of this section, 50 percent of the assets and liabilities of Business A are treated as transferred from Business A to X in a disregarded transaction immediately before the exchange. The result would be the same even if X and Z filed a consolidated return.

Example 11. *Circular transfers*. (i) *Facts*. X owns Business A. On December 30, 2021, Business A purports to transfer €100 to X. On January 2, 2022, X purports to transfer €50 to Business A. On January 4, 2022, X purports to transfer another €50 to Business A. As of the end of 2021, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(ii) *Analysis*. Because the transfer by Business A to X is offset by the transfers from X to Business A that occurred in close temporal proximity, the Internal Revenue Service (IRS) may disregard the purported transfers to and from Business A for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

Example 12. *Transfers without substance*. (i) *Facts*. X owns Business A and Business B. On January 1, 2021, Business A purports to transfer €100 to X. On January 4, 2021, X purports to transfer €100 to Business B. The account in which Business B deposited the €100 is used to pay the operating expenses and other costs of Business A. As of the end of 2021, X has an unrecognized section 987 loss with respect to Business A, such that a remittance, if respected, would result in recognition of a foreign currency loss under section 987.

(ii) *Analysis*. Because Business A continues to have use of the transferred property, the IRS may disregard the €100 purported transfer from Business A to X for purposes of section 987 pursuant to general tax principles under paragraph (c)(7) of this section.

Example 13. *Offsetting positions in section 987 QBUs*. (i) *Facts*. X owns Business A and Business B. Each of Business A and Business B has the euro as its functional currency. X has not made a grouping election under § 1.987–1(b)(2)(ii). On January 1, 2021, X borrows €1,000 from a third party lender, records the liability with respect to the borrowing on the books and records of Business A, and records the borrowed €1,000 on the books and records of Business B. On December 31, 2022, when Business A has $100 of net unrecognized section 987 loss and Business B has $100 of net unrecognized section 987 gain resulting from the change in exchange rates with respect to the liability and the €1,000, X terminates the Business A section 987 QBU.

(ii) *Analysis*. Because Business A and Business B have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine if a principal purpose of recording the euro-denominated liability on the books and records of Business A and the borrowed euros on the books and records of Business B was the avoidance of tax under section 987. If such a principal purpose is present, the IRS may reallocate the items (that is, the euros and the euro-denominated liability) between Business A, Business B, and X, under paragraph (c)(7) of this section to reflect the substance of the transaction.

Example 14. *Offsetting positions with respect to a section 987 QBU and a section 988 transaction*. (i) *Facts*. X owns all of the interests in DE1, and DE1 owns Business A. On January 1, 2021, X borrows €1,000 from a third party lender and records the liability with respect to the borrowing on its books and records. X contributes the €1,000 loan proceeds to DE1 and the €1,000 are reflected on the books and records of Business A. On December 31, 2022, when Business A has $100 of net unrecognized section 987 loss resulting from the change in exchange rates with respect to the €1,000 received from the borrowing, and when the euro-denominated borrowing, if repaid, would result in $100 of gain under section 988, X terminates the Business A section 987 QBU.

(ii) *Analysis*. Because X and Business A have offsetting positions in the euro, the IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the borrowed euros on the books and records of Business A, or not recording the corresponding euro-denominated liability on the books and records of Business A, was the avoidance of tax under section 987. If such a principal purpose is present, the Commissioner may reallocate the items (that is, the euros and the euro-denominated liability) between Business A and X under paragraph (c)(7) of this section to reflect the substance of the transaction.

Example 15. *Offsetting positions with respect to a section 987 QBU and a section 988 transaction*. (i) *Facts*. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y file a consolidated return. On January 1, 2021, DE1 lends €1,000 to Y. X records the receivable with respect to the loan on Business A's books and records. On December 31, 2022, when Business A has $100 of net unrecognized section 987 gain resulting from the loan, Y repays the €1,000 liability. The repayment of the euro-denominated borrowing results in $100 of loss to Y under section 988. X claims a $100 loss on its consolidated return under section 988. Business A does not make any remittances to X in 2022, so the offsetting gain with respect to the loan receivable has not been recognized by X.

(ii) *Analysis*. Y, a related party to X, and Business A have offsetting positions in the euro. The IRS will scrutinize the transaction under paragraph (b)(3) of this section to determine whether a principal purpose of recording the euro-denominated receivable on the books and records of Business A, rather than on the books and records of X, was to avoid tax through the use of section 987. If such a principal purpose is present, the IRS may reallocate the euro-denominated receivable between Business A and X under paragraph (c)(7) of this section to reflect the substance of the transaction. Other provisions may also apply to defer or disallow the loss.

Example 16. Loan by section 987 QBU followed by immediate distribution to owner. (i) *Facts*. X owns all of the interests in DE1. DE1 owns Business A. On January 1, 2021, Business A borrows €1,000 from a bank. On January 2, 2021, Business A distributes the €1,000 it received from the bank to X. There are no other transfers between X and Business A during the year. At the end of the year, X has net unrecognized section 987 loss with respect to Business A such that a remittance would result in the recognition of foreign currency loss under section 987.

(ii) *Analysis*. Because the proceeds from the loan to Business A are immediately transferred to X and the distribution from Business A to X could result in the recognition of section 987 loss, the IRS may scrutinize the recording of the loan on the books of Business A and move the loan onto the books of X, resulting in the transfer not being taken into account for purposes of section 987 under paragraph (b)(3) of this section.

Example 17. Payment of interest by section 987 QBU on obligation of owner. (i) *Facts*. X owns all of the interests in DE1. DE1 owns business A. On January 1, X borrows €1,000 from a bank. On July 1, Business A pays €20 in interest on X's €1,000 obligation to the bank.

(ii) *Analysis*. Under general tax law principles as provided in paragraph (c)(7) of this section, on July 1, 2021, Business A is treated for purposes of section 987 as making a transfer of €20 to X, and X is treated as making a €20 interest payment to the bank.

(d) *Translation of items transferred to a section 987 QBU*—(1) *Marked items*. The adjusted basis of a marked asset, or the amount of a marked liability, transferred to a section 987 QBU shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in § 1.987–1(c)(1)) applicable to the date of transfer. If the asset or liability transferred is denominated in (or determined by reference to) the functional currency of the section 987 QBU (for example, cash or a note denominated in the functional currency of the section 987 QBU), no translation is required. See § 1.988–1(a)(10)(ii) for special rules regarding intra-taxpayer transfers.

(2) *Historic items*. The adjusted basis of a historic asset, or the amount of a historic liability, transferred to a section 987 QBU shall be translated into the section 987 QBU's functional currency at the rate provided in § 1.987–1(c)(3).

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

(a) *In general*. This section provides rules for determining the taxable income or loss, or the earnings and profits, of an owner of a section 987 QBU (hereafter, section 987 taxable income or loss). Paragraph (b) of this section provides rules for determining items of income, gain, deduction, and loss, which generally must be determined in the section 987 QBU's functional currency. Paragraph (c) of this section provides rules for translating each item determined under paragraph (b) of this section into the functional currency of the owner of the section 987 QBU, if necessary. Paragraph (e) of this section provides examples illustrating the application of the rules of this section.

(b) *Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency*—(1) *In general*. Except as otherwise provided in this section, a section 987 QBU shall determine each item of income, gain, deduction, or loss of such section 987 QBU in its functional currency under Federal income tax principles.

(2) *Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency*—(i) *In general*. Except as otherwise provided in paragraphs (b)(2)(ii) and (b)(4) of this section, an item of income, gain, deduction, or loss that is denominated in (or determined by reference to) a nonfunctional currency (including the functional currency of the owner) shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in § 1.987–1(c)(1)) on the date such item is properly taken into account, subject to the limitation under § 1.987–1(c)(1)(ii)(B) regarding the use of a spot rate convention. Examples 1, 2 and 6 of paragraph (e) of this section illustrate the application of this paragraph (b)(2)(i).

(ii) [Reserved].

(3) *Determination in the case of a section 987 QBU owned through a section 987 aggregate partnership*—(i) *In general*. Except as otherwise provided in this paragraph (b)(3), the taxable income or loss of a section 987 aggregate partnership, and the distributive share of any owner that is a partner in such partnership, shall be determined in accordance with the provisions of subchapter K of the Internal Revenue Code.

(ii) *Determination of each item of income, gain, deduction, or loss in the eligible QBU's functional currency*. A section 987 aggregate partnership generally shall determine each item of income, gain, deduction, or loss reflected on the books and records of each of its eligible QBUs under § 1.987–2(b) in the functional currency of each such QBU.

(iii) *Allocation of items of income, gain, deduction, or loss of an eligible QBU*. A section 987 aggregate partnership shall allocate the items of income, gain, deduction, or loss of each eligible QBU among its partners in accordance with each partner's distributive share of such income, gain, deduction, or loss as determined under subchapter K of the Internal Revenue Code.

(iv) *Translation of items into the owner's functional currency*. To the extent the items referred to in paragraph (b)(3)(iii) of this section are allocated to a partner, the partner shall adjust the items to conform to Federal income tax principles and translate the items into the partner's functional currency as provided in paragraph (c) of this section.

(4) [Reserved].

(c) *Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency*—(1) *In general*. Except as otherwise provided in this section, the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss attributable to a section 987 QBU into the owner's functional currency, if necessary, shall be the yearly average exchange rate (as defined in § 1.987–1(c)(2)) for the taxable year. However, an owner of a section 987 QBU that has elected under § 1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates must use the spot rate (as defined in § 1.987–1(c)(1)) for the date each item is properly taken into account.

(2) *Exceptions*—(i) *Recovery of basis with respect to historic assets*. Except as otherwise provided in this section, the exchange rate to be used by the owner in translating any recovery of basis (whether through a sale or exchange; deemed sale or exchange; cost recovery deduction such as depreciation, depletion or amortization; or otherwise) with respect to a historic asset (as defined in § 1.987–1(e)) shall be the historic rate as determined under § 1.987–1(c)(3) for the property to which such recovery of basis is attributable.

(ii) [Reserved].

(iii) *Gain or loss on the sale, exchange or other disposition of an interest in a section 987 aggregate partnership*. [Reserved].

(iv) *Cost of goods sold computation*.—(A) *General rule—simplified inventory method*. Cost of goods sold (COGS) for a taxable year shall be translated into the functional currency of the owner at the yearly average exchange rate (as defined in § 1.987–1(c)(2)) for the taxable year and adjusted as provided in paragraph (c)(3) of this section.

(B) *Election to use the historic inventory method*. In lieu of using the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section, the owner of a section 987 QBU may elect under this paragraph (c)(2)(iv)(B) to translate inventoriable costs (including current-year inventoriable costs and costs that were capitalized into inventory in prior years) that are included in COGS at the historic rate as determined under § 1.987–1(c)(3) for each such cost. As described in § 1.987–1(c)(1)(iii), a taxpayer that elects to use spot rates in lieu of yearly average exchange rates as provided in that section will be deemed to have made the election described in this paragraph (c)(2)(iv)(B).

(3) *Adjustments to COGS required under the simplified inventory method*—(i) *In general*. An owner of a section 987 QBU that uses the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section must make the adjustment described in paragraph (c)(3)(ii) of this section. In addition, the owner must make the adjustment described in paragraph (c)(3)(iii) of this section with respect to any inventory for which the section 987 QBU does not use the LIFO inventory method (as described in section 472) and must make the adjustment described in paragraph (c)(3)(iv) of this section with respect to any inventory for which the section 987 QBU uses the LIFO inventory method. An owner of a section 987 QBU that uses the simplified inventory method must make all of the applicable adjustments described in paragraphs (c)(3)(ii) through (iv) with respect to the section 987 QBU even in taxable years in which the amount of COGS is zero.

(ii) *Adjustment for cost recovery deductions included in inventoriable costs*. The translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) to reflect the difference between the historic rates appropriate for translating cost recovery deductions attributable to other historic assets and the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section, to the extent any such cost recovery deductions are included in inventoriable costs for the taxable year. The adjustment shall be included as an adjustment to translated COGS computed under paragraph (c)(2)(iv)(A) of this section in full in the year to which the adjustment relates and shall not be allocated between COGS and ending inventory. The adjustment for each cost recovery deduction shall be computed as the product of:

(A) The cost recovery deduction, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate specified in paragraph (c)(2)(i) of this section for translating the cost recovery deduction (that is, the historic rate for the property to which such deduction is attributable) less the exchange rate used to translate COGS under the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iii) *Adjustment to beginning inventory for non-LIFO inventory*. In the case of inventory with respect to which a section 987 QBU does not use the LIFO inventory method (non-LIFO inventory), the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The ending non-LIFO inventory included on the closing balance sheet for the preceding year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§ 1.987–4(e)(2)(ii) and 1.987–1(c)(3)(i)(C) that is used for translating ending inventory on the closing balance sheet for the preceding year (that is, the yearly average exchange rate for the preceding year) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iv) *Adjustment for year of LIFO liquidation*. In the case of inventory with respect to which a section 987 QBU uses the LIFO inventory method, for each LIFO layer liquidated in whole or in part during the taxable year, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The amount of the LIFO layer liquidated during the taxable year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§ 1.987–4(e)(2)(ii) and 1.987–1(c)(3)(i)(C) that is used for translating such LIFO layer (that is, the yearly average exchange rate for the year such LIFO layer arose) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(d) [Reserved].

(e) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the U.S. dollar as its functional currency. Except as otherwise indicated, U.S. Corp is the owner of Business A, a section 987 QBU with the euro as its functional currency, and elects under paragraph (c)(2)(iv)(B) of this section to use the historic inventory method with respect to Business A but does not make any other elections under section 987. However, where it is specified that U.S. Corp elects to use spot rates in lieu of yearly average exchange rates under § 1.987–1(c)(1)(iii), U.S. Corp also elects under § 1.987–1(c)(1)(ii) to use a spot rate convention. Under this convention, sales booked during a particular month are translated at the average of the spot rates on the first and last day of the preceding month (the "convention rate"). Exchange rates used in these examples are selected for the purpose of illustrating the principles of this section. No inference (for example, whether a currency is hyperinflationary or not) is intended by their use. See § 1.987–4(g) for an illustration of the simplified inventory method described in paragraphs (c)(2)(iv)(A) and (c)(3) of this section.

Example 1. Business A properly accrues £100 of income from the provision of services. Under paragraph (b)(2)(i) of this section, the £100 is translated into €90 at the spot rate (as defined in § 1.987–1(c)(1)) on the date of accrual, without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €90 of income is translated into dollars at the rate provided in paragraph (c)(1) of this section.

Example 2. Business A sells a historic asset consisting of non-inventory property for £100. Under paragraph (b)(2)(i) of this section, the £100 amount realized is translated into €85 at the spot rate (as defined in § 1.987–1(c)(1)) on the sale date without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €85 is translated into dollars at the rate provided in paragraph (c)(1) of this section. The euro basis of the property is translated into dollars at the rate provided in paragraph (c)(2)(i) of this section (that is, the historic rate as determined under § 1.987–1(c)(3)).

Example 3. (i) Business A uses a first-in, first-out (FIFO) method of accounting for inventory. Business A sells 1,200 units of inventory in 2021 for €3 per unit. Business A's gross sales are translated under paragraph (c)(1) of this section at the yearly average exchange rate for the year of the sale. The yearly average exchange rate is €1 = $1.02 for 2020 and €1 = $1.05 for 2021. Thus, Business A's dollar gross sales will be computed as follows:

Gross Sales (2021)

Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Jan	100	€300	€1 = $1.05	$ 315.00
Feb	200	600	€1 = $1.05	630.00
March	0	0	€1 = $1.05	0
April	200	600	€1 = $1.05	630.00
May	100	300	€1 = $1.05	315.00
June	0	0	€1 = $1.05	0
July	100	300	€1 = $1.05	315.00
Aug	100	300	€1 = $1.05	315.00
Sept	0	0	€1 = $1.05	0
Oct	0	0	€1 = $1.05	0
Nov	100	300	€1 = $1.05	315.00
Dec	300	900	€1 = $1.05	945.00
	1,200			$3,780.00

(ii) The purchase price for each inventory unit was €1.50. Under § 1.987–1(c)(3)(i) and paragraph (c)(2)(iv)(B) of this section, the basis of each item of inventory is translated into dollars at the yearly average exchange rate for the year the inventory was acquired.

Opening Inventory and Purchases (2021)

Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Opening inventory (purchased in Dec. 2020)				
	100	€150	€1=$1.02	$153.00
Purchases in 2021				
Jan	300	€450	€1=$1.05	$472.50
Feb	0	0	€1=$1.05	0
March	0	0	€1=$1.05	0
April	300	450	€1=$1.05	472.50
May	0	0	€1=$1.05	0
June	0	0	€1=$1.05	0
July	300	450	€1=$1.05	472.50
Aug	0	0	€1=$1.05	0
Sept	0	0	€1=$1.05	0
Oct	0	0	€1=$1.05	0

Opening Inventory and Purchases (2021)				
Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Nov	300	450	€1=$1.05	472.50
Dec	0	0	€1=$1.05	0
	1,200			$1,890.00

(iii) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in 2020 ($153.00), the 300 units purchased in January 2021 ($472.50), the 300 units purchased in April 2021 ($472.50), the 300 units purchased in July 2021 ($472.50), and 200 of the 300 units purchased in November 2021 ($315.00). Accordingly, Business A's translated dollar COGS for 2021 is $1,885.50. Business A's opening inventory for 2022 is 100 units of inventory with a translated dollar basis of $157.50.

(iv) Accordingly, for purposes of section 987 Business A has gross income in dollars of $1,894.50 ($3,780.00 – $1,885.50).

Example 4. (i) The facts are the same as in *Example 3* except that U.S. Corp properly elects under paragraph § 1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates. As a result, under paragraph (c)(3) of this section, U.S. Corp uses the convention rate to translate items of income, gain, deduction, or loss where such rate is appropriate. Thus, Business A's dollar gross sales will be computed as follows:

Gross Sales (2021)				
Sales	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Jan	100	€300	€1 = $1.00	$300
Feb	200	600	€1 = $1.05	630
March	0	0	€1 = $1.03	0
April	200	600	€1 = $1.02	612
May	100	300	€1 = $1.04	312
June	0	0	€1 = $1.05	0
July	100	300	€1 = $1.06	318
Aug	100	300	€1 = $1.05	315
Sept	0	0	€1 = $1.06	0
Oct	0	0	€1 = $1.07	0
Nov	100	300	€1 = $1.08	324
Dec	300	900	€1 = $1.08	972
	1,200			$3,783

(ii) As in *Example 3*, the purchase price for each inventory unit was €1.50. Under § 1.987–3(c)(2)(iv)(B), U.S. Corp uses the convention rate as the historic rate in determining COGS.

Opening Inventory and Purchases (2021)				
Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Opening inventory (purchased in Dec. 2020)				
	100	€150	€1 = $1.00	$150
Purchases in 2021				
Jan	300	€450	€1 = $1.00	$450
Feb	0	0	€1 = $1.05	0
March	0	0	€1 = $1.03	0
April	300	450	€1 = $1.02	459
May	0	0	€1 = $1.04	0
June	0	0	€1 = $1.05	0
July	300	450	€1 = $1.06	477
Aug	0	0	€1 = $1.05	0
Sept	0	0	€1 = $1.06	0

Opening Inventory and Purchases (2021)				
Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Oct	0	0	€1 = $1.07	0
Nov	300	450	€1 = $1.08	486
Dec	0	0	€1 = $1.08	0
	1,200			$1,872

(iii) As set forth in (i), Business A's gross sales are $3783.

(iv) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in December 2020 ($150), the 300 units purchased in January 2021 ($450), the 300 units purchased in April 2021 ($459), the 300 units purchased in July 2021 ($477), and 200 of the 300 units purchased in November 2021 ($324). Thus, Business A's COGS is $1,860.

(v) Accordingly, Business A has gross income in dollars of $1,923 ($3,783 – $1,860).

Example 5. The facts are the same as in *Example 3* except that during 2021, Business A incurred €100 of depreciation expense with respect to a truck. No portion of the depreciation expense is an inventoriable cost. The truck was purchased on January 15, 2020. The yearly average exchange rate for 2020 was €1 = $1.02. Under paragraph (c)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic rate. Under § 1.987–1(c)(3)(i), the historic rate is the yearly average rate for 2020. Accordingly, U.S. Corp takes into account depreciation of $102 with respect to Business A in 2021.

Example 6. The facts are the same as in *Example 5* except that the €100 of depreciation expense incurred during 2021 with respect to the truck is an inventoriable cost. As a result, the depreciation expense is capitalized into the 1,200 units of inventory purchased by Business A in 2021. Of those 1,200 units, 1,100 units are sold during the year, and 100 units become ending inventory. The portion of depreciation expense capitalized into inventory that is sold during 2021 is reflected in Business A's euro COGS and is translated at the €1 = $1.02 yearly average exchange rate for 2020, the year in which the truck was purchased. The portion of the depreciation expense capitalized into the 100 units of ending inventory is not taken into account in 2021 but, rather, will be taken into account in the year the ending inventory is sold, translated at the €1 = $1.02 yearly average exchange rate for 2020.

Example 7. Business A purchased raw land on October 16, 2020, for €8,000 and sold the land on November 1, 2021, for €10,000. The yearly average exchange rate was €1 = $1.02 for 2020 and €1 = $1.05 for 2021. Under paragraph (c)(1) of this section, the amount realized is translated into dollars at the yearly average exchange rate for 2021 (€10,000 x $1.05 = $10,500). Under paragraph (c)(2)(i) of this section, the basis is determined at the historic rate for 2020, which is the yearly average rate under section § 1.987–1(c)(3)(i) for such year (€8,000 x $1.02 = $8,160). Accordingly, the amount of gain reported by U.S. Corp on the sale of the land is $2,340 ($10,500 – $8,160).

Example 8. The facts are the same as in *Example 7* except that Business A properly elects under paragraph § 1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average rates. Accordingly, the amount realized will be translated at the convention rate for the date of sale, and the basis will be translated at the convention rate for the date of purchase. The convention rate is €1 = $1.01 for October 2020 and is €1 = $1.08 for November 2021. Under these facts, the amount realized, translated into dollars at the convention rate for November 2021, is $10,800 (€10,000 x $1.08), and the basis, translated at the convention rate for October 2020, is $8,080 (€8,000 x $1.01). The amount of gain reported by U.S. Corp on the sale of the land is $2,720 ($10,800 – $8,080).

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

(a) *In general*. The net unrecognized section 987 gain or loss of a section 987 QBU shall be determined by the owner annually as provided in paragraph (b) of this section in the owner's functional currency. Only assets and liabilities reflected on the books and records of the section 987 QBU under § 1.987–2(b) shall be taken into account.

(b) *Calculation of net unrecognized section 987 gain or loss*. Net unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall equal the sum of:

(1) The section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years to which these regulations apply as determined in paragraph (c) of this section, and

(2) The section 987 QBU's unrecognized section 987 gain or loss for the current taxable year as determined in paragraph (d) of this section.

(c) *Net accumulated unrecognized section 987 gain or loss for all prior taxable years*—(1) *In general*. A section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is the aggregate of the amounts determined under § 1.987–4(d) for all prior taxable years to which these regulations apply, reduced by the amounts taken into account under § 1.987–5 upon remittances for all such prior taxable years.

(2) [Reserved].

(d) *Calculation of unrecognized section 987 gain or loss for a taxable year.* The unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall be determined under paragraphs (d)(1) through (8) of this section.

(1) *Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year*—(i) *In general*. The change in the owner functional currency net value of the section 987 QBU for the taxable year shall equal—

(A) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the taxable year; less

(B) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the preceding taxable year. This amount shall be zero in the case of the section 987 QBU's first taxable year.

(ii) *Year section 987 QBU is terminated*. If a section 987 QBU is terminated within the meaning of § 1.987–8 during an owner's taxable year, the owner functional currency net value of the section 987 QBU as provided in paragraph (d)(1)(i)(A) of this section shall be determined on the date the section 987 QBU is terminated.

(2) *Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner*—(i) *In general.* The amount determined in paragraph (d)(1) of this section shall be increased by the total amount

of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section.

(ii) *Assets transferred from the section 987 QBU to the owner during the taxable year*. The assets transferred from the section 987 QBU to the owner for the taxable year shall equal the sum of:

(A) The amount of the section 987 QBU's functional currency and the aggregate adjusted basis of all marked assets (as defined in § 1.987–1(d)), after taking into account § 1.988–1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the spot rate (as defined in § 1.987–1(c)(1)) applicable to the date of transfer; and

(B) The aggregate adjusted basis of all historic assets (as defined in § 1.987–1(e)), after taking into account § 1.988–1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the historic rate for each such asset (as defined in § 1.987–1(c)(3)).

(3) *Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU*—(i) *In general*. The aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section shall be decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner as provided in paragraph (d)(3)(ii) of this section.

(ii) *Total of all amounts transferred from the owner to the section 987 QBU during the taxable year*. The total amount of assets transferred from the owner to the section 987 QBU for the taxable year shall equal the aggregate of:

(A) The total amount of functional currency of the owner transferred to the section 987 QBU during the taxable year; and

(B) The adjusted basis, determined in the functional currency of the owner, of any asset transferred to the section 987 QBU during the taxable year (after taking into account § 1.988–1(a)(10)).

(4) *Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner*. The aggregate amount determined in paragraphs (d)(1) through (3) of this section shall be decreased by the aggregate amount of liabilities transferred from the section 987 QBU to the owner during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate (as defined in § 1.987–1(c)(1)) applicable on the date of transfer.

(5) *Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU*. The aggregate amount determined in paragraphs (d)(1) through (4) of this section shall be increased by the aggregate amount of liabilities transferred by the owner to the section 987 QBU during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate (as defined in § 1.987–1(c)(1)) applicable on the date of transfer.

(6) *Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year*. The aggregate amount determined in paragraphs (d)(1) through (5) of this section shall be decreased or increased by the section 987 taxable income or loss, respectively, computed under § 1.987–3 for the taxable year.

(7) *Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year*. The aggregate amount determined under paragraphs (d)(1) through (6) shall be increased by the amount of any expense or loss attributable to a section 987 QBU for the taxable year that is not deductible in computing the section 987 QBU's taxable income or loss for the year, including any foreign income taxes incurred by the section 987 QBU with respect to which the owner claims a credit (translated at the same rate at which such taxes were translated under section 986(a)).

(8) *Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any tax-exempt income*. The aggregate amount determined under paragraphs (d)(1) through (7) shall be decreased by the amount of any income or gain attributable to a section 987 QBU for the taxable year that is not included in computing the section 987 QBU's taxable income or loss for the year.

(e) *Determination of the owner functional currency net value of a section 987 QBU*—(1) *In general*. The owner functional currency net value of a section 987 QBU on the last day of a taxable year shall equal the aggregate amount of functional currency and the adjusted basis of each asset on the section 987 QBU's balance sheet on that day, less the aggregate amount of each liability on the section 987 QBU's balance sheet on that day, in each case translated into the owner's functional currency as provided in paragraph (e)(2) of this section. Such amount shall be determined by:

(i) Preparing a balance sheet for the relevant date from the section 987 QBU's books and records (within the meaning of § 1.989(a)–1(d)), as recorded in the section 987 QBU's functional currency and showing all assets and liabilities reflected on such books and records as provided in § 1.987–2(b);

(ii) Making adjustments necessary to conform the items reflected on the balance sheet described in paragraph (e)(1)(i) of this section to United States tax accounting principles; and

(iii) Translating the asset and liability amounts on the adjusted balance sheet described in paragraph (e)(1)(ii) of this section into the functional currency of the owner in accordance with paragraph (e)(2) of this section.

(2) *Translation of balance sheet items into the owner's functional currency*. The amount of the section 987 QBU's functional currency, the basis of an asset, or the amount of a liability shall be translated as follows:

(i) *Marked item*. A marked item (as defined in § 1.987–1(d)) shall be translated into the owner's functional currency at the spot rate (as defined in § 1.987–1(c)(1)) applicable to the last day of the relevant taxable year.

(ii) *Historic item*. A historic item (as defined in § 1.987–1(e)) shall be translated into the owner's functional currency at the historic rate (as defined in § 1.987–1(c)(3)).

(f) [Reserved].

(g) *Examples.* The following examples illustrate the provisions of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the dollar as its functional currency. Except as otherwise indicated, U.S. Corp elects under § 1.987–3(c)(2)(iv)(B) to use the historic inventory method with respect to all of its section 987 QBUs but does not make other elections under section 987. Exchange rate and tax accounting (for example, depreciation rate) assumptions used in these examples are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the examples are not intended to demonstrate when activities constitute a trade or business within the meaning of § 1.989(a)–1(b)(2)(ii)(A) and § 1.989(a)–1(c) and therefore whether a section 987 QBU is considered to exist.

Example 1. (i) On July 1, 2021, U.S. Corp establishes Japan Branch, a section 987 QBU of U.S. Corp that has the yen as its functional currency, and transfers to Japan Branch $1,000 and raw land with a basis of $500. Japan Branch immediately exchanges the $1,000 for ¥100,000. On the same day, Japan Branch borrows ¥10,000. For the taxable year 2021, Japan Branch earns ¥2,000 per month (total of ¥12,000 for the six-month period from July 1, 2021, through December 31, 2021) for providing services and incurs ¥333.33 per month (total of ¥2,000 when rounded for the six-month period from July 1, 2021, through December 31, 2021) of related expenses. Assume that the spot rate on July 1, 2021, is $1 = ¥100; the spot rate on December 31, 2021, is $1 = ¥120; and the average rate for the period of July 1, 2021, to December 31, 2021, is $1 = ¥110. Thus, the ¥12,000 of services revenue when properly translated under § 1.987–3(c)(1) at the yearly average exchange rate equals $109.09 (¥12,000 x ($1 / ¥110)) = $109.09). The ¥2,000 of expenses translated at the same yearly average exchange rate equals $18.18 (¥2,000 x ($1 / ¥110) = $18.18). Thus, Japan Branch's net income translated into dollars equals $90.91 ($109.09 – $18.18 = $90.91).

(ii) Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for 2021. Because this is Japan Branch's first taxable year, the net unrecognized section 987 gain or loss (as defined under paragraph (b) of this section) is the branch's unrecognized section 987 gain or loss for 2021 as determined in paragraph (d) of this section. The calculation under paragraph (d) of this section is made as follows:

(iii) *Step 1*. Under paragraph (d)(1) of this section, U.S. Corp must determine the change in the owner functional currency net value (OFCNV) of Japan Branch for 2021 in dollars. The change in the OFCNV of Japan Branch for 2021 is equal to the OFCNV of Japan Branch determined in dollars on the last day of 2021, less the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year.

(A) The OFCNV of Japan Branch determined in dollars on the last day of the current taxable year is determined under paragraph (e) of this section as the sum of the basis of each asset on Japan Branch's balance sheet on December 31, 2021, less the sum of each liability on Japan Branch's balance sheet on that date, translated into dollars as provided in paragraph (e)(2) of this section.

(B) For this purpose, Japan Branch will show the following assets and liabilities on its balance sheet for December 31, 2021:

(1) ¥120,000;

(2) Raw land with a basis of ¥55,000 ($500 translated under § 1.987–2(d)(2) at the historic rate of $1 = ¥110); and

(3) Liabilities of ¥10,000.

(C) Under paragraph (e)(2) of this section, U.S. Corp will translate these items as follows. The ¥120,000 is a marked asset and the ¥10,000 liability is a marked liability (as each is defined in § 1.987–1(d)). These items are translated into dollars on December 31, 2021, using the spot rate on December 31, 2021, of $1 = ¥120. The raw land is a historic asset (as defined in § 1.987–1(e)) and is translated into dollars under paragraph (e)(2)(ii) of this section at the historic rate, which under § 1.987–1(c)(3)(1)(A) is the yearly average exchange rate of $1 = ¥110 applicable to the year the land was transferred to the QBU. Thus, the OFCNV of Japan Branch on December 31, 2021, in dollars is $1,416.67 determined as follows:

Assets	*Amount in ¥*	*Translation Rate*	*Amount in $*
Yen	¥120,000	$1 = ¥120 (spot rate-12/31/21)	$1,000.00
Land	55,000	$1 = ¥110 (yearly average rate-2021)	*500.00*
Total assets			$1,500.00
Liabilities			
Bank Loan	¥10,000	$1 = ¥120 (spot rate-12/31/21)	$83.33
Total liabilities			$83.33
2021 ending OFCNV			$1,416.67

(D) Under paragraph (d)(1) of this section, the change in OFCNV of Japan Branch for 2021 is equal to the OFCNV of the branch determined in dollars on December 31, 2021, ($1,416.67) less the OFCNV of the branch determined in dollars on the last day of the preceding taxable year. Because this is the first taxable year of Japan Branch, the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year is zero under paragraph (d)(1)(i)(B) of this section. Accordingly, the change in OFCNV of Japan Branch for 2021 is $1,416.67.

(iv) *Step 2*. Under paragraph (d)(2) of this section, the aggregate amount determined in paragraph (d)(1) of this section (step 1) is increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section. Because no such amounts were transferred, there is no change in the $1,416.67 determined in step 1.

(v) *Step 3*. Under paragraph (d)(3) of this section, the aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section (steps 1 and 2) is decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year as determined in paragraph (d)(3)(ii) of this section in dollars. On July 1, 2021, U.S. Corp transferred to Japan Branch $1,000.00 (which Japan Branch immediately converted into ¥100,000) and raw land with a basis of $500.00 (equal to ¥55,000, translated under § 1.987–2(d)(2) at the historic rate of $1 = ¥110). Thus, the $1,416.67 determined under steps 1 and 2 is reduced by $1,500.00, resulting in ($83.33).

(vi) *Steps 4 and 5*. Because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year, the aggregate amount determined in paragraph (d)(3) of this section (Step 3) is not increased or decreased.

(vii) *Step 6*. Under paragraph (d)(6) of this section, the aggregate amount determined after applying paragraphs (d)(1) through (5) of this section (steps 1 through 5) is decreased by the section 987 taxable income of Japan Branch of $90.91 from ($83.33) to ($174.24).

(viii) *Steps 7 and 8*. Paragraphs (d)(7) and (d)(8) do not apply because Japan Branch does not have any tax-exempt or nondeductible items. Accordingly, the unrecognized section 987 loss of Japan Branch for 2021 is ($174.24), the amount determined after applying step 6.

Example 2. (i) U.S. Corp operates in the United Kingdom through U.K. Branch, a section 987 QBU of U.S. Corp that has the pound as its functional currency. U.S. Corp properly elects under § 1.987–1(c)(1)(ii) for U.K. Branch to use a spot rate convention (when permitted). Under the chosen convention, the spot rate (the "convention rate") for any transaction occurring during a month is the average of the pound spot rate and the 30-day forward rate for pounds on the next-to-last Thursday of the preceding month. The yearly average exchange rate was £1 = $0.90 for 2020, £1 = $1.00 for 2021, and £1 = $1.10 for 2022. The closing balance sheet of U.K. Branch in 2021 reflected the following assets:

(A) £100;

(B) A sales office purchased in 2020 with an adjusted basis of £1,000;

(C) A delivery truck purchased in 2020 with an adjusted basis of £200;

(D) Inventory of 100 units purchased in 2021 with a basis of £100; and

(E) Stock in ABC Corporation purchased in 2021 with a basis of £150, representing less than 10 percent of the total voting power and value of all classes of stock of ABC Corporation.

The closing balance sheet of U.K. Branch for 2021 reflected one liability, £50 of long-term debt entered into in 2020 with F Bank, an unrelated bank.

The office, truck, stock, and inventory are historic assets (as defined in § 1.987–1(e)). The £100 and long-term debt are marked items (as defined in § 1.987–1(d)). Assume that U.S. Corp translated U.K. Branch's 2021 closing balance sheet as follows:

Assets	*Amount in £*	*Translation Rate*	*Amount in $*
Pounds	£100.00	£1 = $1.05 (convention rate-Dec. 2021)	$105.00
Office	1,000.00	£1 = $0.90 (historic rate-2020)	900.00
Truck	200.00	£1 = $0.90 (historic rate-2020)	180.00
Stock	50.00	£1 = $1.00 (historic rate-2021)	150.00
Inventory	100.00	£1 = $1.00 (historic rate-2021)	100.00
Total assets			$1435.00
Liabilities			
Bank Loan	£50.00	£1 = $1.05 (convention rate-Dec. 2021)	$52.50
Total liabilities			$52.50
2021 ending OFCNV			$1,382.50

(ii) U.K. Branch uses the first-in, first-out (FIFO) method of accounting for inventory. In 2022, U.K. Branch sold 100 units of inventory for a total of £300 and purchased another 100 units of inventory for £100. There is depreciation of £33 with respect to the office and £40 with respect to the truck, and U.K. Branch incurred £30 of business expenses during 2022. Neither the depreciation nor the business expenses are inventoriable costs. All items of income earned and expenses incurred during 2022 are received and paid, respectively, in pounds. Under § 1.987–3, U.K. Branch's section 987 taxable income or loss is determined as follows:

Item	*Amount in £*	*Translation Rate*	*Amount in $*
Gross receipts	£300.00	£1 = $1.10 (yearly average rate-2022)	$330.00
Less: COGS	(100.00)	£1 = $1.00 (historic rate-2021)	(100.00)
Gross income			$230.00
Dep: Office	(33.00)	£1 = $0.90 (historic rate-2020)	($29.70)
Truck	(40.00)	£1 = $0.90 (historic rate-2020)	(36.00)
Other expenses	(30.00)	£1 = $1.10 (yearly average rate-2022)	(33.00)
Total expenses			($98.70)
Section 987 taxable income			$131.30

Accordingly, U.K. Branch has $131.30 of section 987 taxable income in 2022.

(iii) In December 2022, U.K. Branch transferred £30 to U.S. Corp, and U.S. Corp transferred a computer with a basis of $10 to U.K. Branch. U.S. Corp's net accumulated unrecognized section 987 gain or loss for all prior taxable years as determined in paragraph (c) of this section is $30.

(iv) The unrecognized section 987 gain or loss of U.K. Branch for 2022 is determined as follows:

(A) *Step 1*. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of U.K. Branch determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of U.K. Branch determined on the last day of 2021. The OFCNV of U.K. Branch on December 31, 2022, and the change in OFCNV for 2022, are determined as follows:

Assets	*Amount in £*	*Translation Rate*	*Amount in $*
Pounds	£240.00	£1 = $1.15 (convention rate-Dec. 2022)	$276.00
Office	967.00	£1 = $0.90 (historic rate-2020)	870.30
Truck	160.00	£1 = $0.90 (historic rate-2020)	144.00
Inventory	100.00	£1 = $1.10 (historic rate-2022)	110.00
Computer	9.09	£1 = $1.10 (historic rate-2022)	10.00
Stock	150.00	£1 = $1.00 (historic rate-2021)	150.00
Total assets			$1,560.30
Liabilities			
Bank Loan	£50.00	£1 = $1.15 (convention rate-Dec. 2022)	$57.50
Total liabilities			$57.50
2022 ending OFCNV			$1,502.80
Less: 2021 ending OFCNV			(1,*382.50)*
Change in OFCNV			$120.30

(B) *Step 2*. Under paragraph (d)(2) of this section, the aggregate amount determined in step 1 must be increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from U.K. Branch to U.S. Corp during the taxable year, translated into U.S. Corp's functional currency as provided in paragraph (d)(2)(ii) of this section. The amount of assets transferred from U.K. Branch to U.S. Corp during 2022 is determined as follows:

Asset	*Amount in £*	*Translation Rate*	*Amount in $*
£30	£30.00	£1 = $1.15 (convention rate-Dec. 2022)	$34.50

(C) *Step 3: Decrease the aggregate amount described in steps 1 and 2 by the owner's transfers to the section 987 QBU*. Under paragraph (d)(3) of this section, the aggregate amount determined in steps 1 and 2 must be decreased by the total amount of all assets transferred from U.S. Corp to U.K. Branch during the taxable year as determined in paragraph (d)(3)(ii) of this section. The amount of assets transferred from U.S. Corp to U.K. Branch during 2022 is determined as follows:

Assets	*Amount in $*
Computer	$10.00

(D) *Step 4*. Under paragraph (d)(4) of this section, the aggregate amount determined in steps 1 through 3 must be decreased by the aggregate amount of liabilities transferred by U.K. Branch to U.S. Corp. Under these facts, such amount is $0.

(E) *Step 5*. Under paragraph (d)(5) of this section, the aggregate amount determined in steps 1 through 4 must be increased by the aggregate amount of liabilities transferred by U.S. Corp to U.K. Branch. Under these facts, such amount is $0.

(F) *Step 6*. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 is decreased or increased, respectively, by any section 987 taxable income or loss of U.K. Branch computed under § 1.987–3 for the taxable year. The amount of U.K. Branch's taxable income, as determined above, is $131.30.

(H) *Steps 7 and 8*: Paragraphs (d)(7) and (d)(8) do not apply because U.K. Branch does not have any tax-exempt income or nondeductible expense.

(v) *Summary*. Taking steps 1 through 8 into account, the amount of U.S. Corp's unrecognized section 987 gain or loss with respect to U.K. Branch in 2022 is computed as follows:

Step	*Amount in $*	*Balance*
1	+$120.30	$120.30
2	+34.50	154.80
3	-10.00	144.80
4	-0	144.80
5	+0	144.80
6	-131.30	13.50
7	+0	13.50
8	-0	13.50

Thus, U.S. Corp's unrecognized section 987 gain for 2022 with respect to U.K. Branch is $13.50. As of the end of 2022, before taking into account the recognition of any section 987 gain or loss under § 1.987–5, U.S. Corp's net unrecognized section 987 gain is $43.50 (that is, $30.00 accumulated from prior years, plus $13.50 in 2022).

Example 3. (i) *Background*. U.S. Corp is the owner of Business A, a section 987 QBU that has the euro as its functional currency. Business A uses the FIFO method to account for inventory and uses the simplified inventory method described in § 1.987–3(c)(2)(iv)(A). On the last day of 2020, U.S. Corp begins Business A by contributing to Business A a building with a basis of $780, a machine with a basis of $300, and $100. On January 1, 2021, Business A converts the $100 into €100. The tax basis of the building and machine is translated into euros using the historic rate, which is the yearly average exchange rate for 2020, the year of the transfer. Accordingly, the building and the machine have a tax basis of €780 and €300, respectively, on December 31, 2020. The building and machine have annual depreciation of €20 and €30, respectively. Business A determines that 50 percent of the building depreciation should be allocated to the cost of goods manufactured (that is, treated as an inventoriable cost) and 50 percent should be allocated to selling, general and administrative (SG&A) expenses. The machine is used exclusively to manufacture inventory. Relevant exchange rates for purposes of this example are as follows:

Year	*Yearly Average Exchange Rate*	*December 31 Spot Rate*
2020	€1 = $1.00	€1 = $1.00
2021	€1 = $1.50	€1 = $2.00
2022	€1 = $2.50	€1 = $3.00

(ii) *Operations in 2021*. During 2021, Business A recognizes €140 of revenue from sales of finished goods. The related COGS is €70. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2021 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2021, shows no liabilities and the following assets: currency of €160, the building with an adjusted basis of €760, the machine with an adjusted basis of €270, and ending inventory with a FIFO cost basis of €40, comprising raw materials and finished goods.

(A) *Determination of income*. Under the simplified inventory method, Business A's income for 2021 is computed as follows:

Item	*Amount in €*	*Translation Rate*	*Amount in $*
Sales revenue	€140	€1 = $1.50 (yearly avg. rate-2021)	$210
COGS before adjustments	70	€1 = $1.50 (yearly avg. rate-2021)	$105
Adjustment for cost recovery deductions (see calculation below)			(20)
Adjustment for beginning inventory (none)			0
Adjusted COGS			$85
SG&A			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate-2020)	$10
Salaries	10	€1 = $1.50 (yearly avg. rate-2021)	15
Total SG&A			$25
Section 987 net income (revenue less COGS and SG&A)			$100

COGS Adjustments

Adjustment for cost recovery deductions included in inventoriable costs

Depreciation Amount	*Historic Rate*	*2021 Yearly Avg. Rate*	*Difference in Translation Rates*	*Adjustment (Depreciation x Change in Rates)*
€10 (building)	1.00	1.50	(0.50)	($5)
€30 (machine)	1.00	1.50	(0.50)	*($15)*
Total adjustment for cost recovery deductions				($20)

(B) *Determination of OFCNV for 2020 and 2021*.

Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV-End of 2021			
Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€160	€1 = $2.00 (year-end spot rate-2021)	$320
Building	760	€1 = $1.00 (historic rate-2020)	760
Machine	270	€1 = $1.00 (historic rate-2020)	270
Inventory	40	€1 = $1.50 (yearly average rate-2021)	60
Total assets			$1,410
Liabilities			
Total liabilities			$0
2021 ending OFCNV			$1,410

OFCNV-End of 2020			
Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€100	€1 = $1.00 (year-end spot rate-2020)	$100
Building	780	€1 = $1.00 (historic rate-2020)	780
Machine	300	€1 = $1.00 (historic rate-2020)	*300*
Total assets			$1,180
Liabilities			
Total liabilities			$0
2020 ending OFCNV			$1,180

(C) *Determination of net unrecognized section 987 gain or loss*. The net unrecognized section 987 gain or loss of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1*. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	$1,410
Less: 2020 ending OFCNV	*(1,180)*
Change in OFCNV	$230

(*2*) *Step 6*. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is $100.

Change in OFCNV	$230
Less: section 987 taxable income	*(100)*
Unrecognized section 987 gain	$130
Plus: net accumulated unrecognized section 987 gain or loss from prior years	0
Net unrecognized section 987 gain	$130

(iii) *Operations in 2022*. During 2022, Business A recognizes €180 of revenue from sales of finished goods. The related COGS is €96. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2022 include €30 of depreciation on the machine and €10 of depreciation on the building. Business A's balance sheet on December 31, 2022, shows no liabilities and the following assets: currency of €260, the building with an adjusted basis of €740, the machine with an adjusted basis of €240, and ending inventory with a FIFO cost basis of €54, comprising raw materials and finished goods.

(A) *Determination of income*. Under the simplified inventory method, Business A's income for 2022 is computed as follows:

Item	Amount in €	Translation Rate	Amount in $
Sales revenue	€180	€1 = $2.50 (yearly avg. rate-2022)	$450
COGS before adjustments	96	€1 = $2.50 (yearly avg. rate-2022)	$240
Adjustment for cost recovery deductions (see calculation below)			(60)
Adjustment for beginning inventory (see calculation below)			*(40)*
Adjusted COGS			$140
SG&A			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate-2020)	$10
Salaries	10	€1 = $2.50 (yearly avg. rate-2022)	25
Total SG&A			$35
Section 987 net income (revenue less COGS and SG&A)			$275

COGS Adjustments

Adjustment for cost recovery deductions

Depreciation Amount	*Historic Rate*	*2022 Yearly Avg. Rate*	*Difference in Translation Rates*	*Adjustment (Depreciation x Change in Rates)*
€10 (building)	1.00	2.50	(1.50)	($15)
€30 (machine)	1.00	2.50	(1.50)	*($45)*
Total adjustment for cost recovery deductions				($60)

Adjustment for beginning inventory

Prior Year Ending Inventory	*2021 Yearly Avg. Rate*	*2022 Yearly Avg. Rate*	*Difference in Translation Rates*	*Adjustment (Inventory x Change in Rates)*
€40	1.50	2.50	(1.00)	*($40)*
Total adjustment for beginning inventory				($40)

(B) *Determination of OFCNV*. Under the simplified inventory method, the OFCNV of Business A for 2022 is determined under paragraph (e) of this section as follows:

OFCNV-End of 2022

Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€260	€1 = $3.00 (year-end spot rate-2022)	$780
Building	740	€1 = $1.00 (historic rate-2020)	740
Machine	240	€1 = $1.00 (historic rate-2020)	240
Inventory	54	€1 = $2.50 (yearly average rate-2022)	*135*
Total assets			$1,895
Liabilities			
Total liabilities			$0
2022 ending OFCNV			$1,895

(C) *Determination of net unrecognized section 987 gain or loss*. The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1*. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	$1,895
Less: 2021 ending OFCNV	*(1,410)*
Change in OFCNV	$485

(*2*) *Step 6*. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is $275.

Change in OFCNV	$485
Less: section 987 taxable income	*(275)*
Unrecognized section 987 gain 2022	$210
Plus: net accumulated unrecognized section 987 gain from prior year	130
Net unrecognized section 987 gain	$340

Example 4. (i) *Background*. The background facts about Business A are the same as in *Example 3*, except that Business A uses the dollar-value LIFO method to account for inventory.

(ii) *Operations in 2021*. The facts about Business A's operations in 2021 are the same as in *Example 3*.

(A) *Determination of income*. Under the simplified inventory method, Business A's income for 2021 is computed as follows:

Item	*Amount in €*	*Translation Rate*	*Amount in $*
Sales revenue	€140	€1 = $1.50 (yearly avg. rate-2021)	$210
COGS before adjustments	70	€1 = $1.50 (yearly avg. rate-2021)	$105
Adjustment for cost recovery deductions (same as *Example 1*)			(20)
Adjustment for LIFO liquidation (none)			0
Adjusted COGS			$85
SG&A			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate-2020)	$10
Salaries	10	€1 = $1.50 (yearly avg. rate-2021)	15
Total SG&A			$25
Section 987 net income (revenue less COGS and SG&A)			$100

(B) *Determination of OFCNV for 2020 and 2021*. Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV-End of 2021

Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€160	€1 = $2.00 (year-end spot rate-2021)	$320
Building	760	€1 = $1.00 (historic rate-2020)	760
Machine	270	€1 = $1.00 (historic rate-2020)	270
Inventory	40	€1 = $1.50 (historic rate-2021)	60
Total assets			$1,410
Liabilities			

OFCNV-End of 2021			
Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Total liabilities			$0
2021 ending OFCNV			$1,410

OFCNV-End of 2020			
Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€100	€1 = $1.00 (year-end spot rate-2020)	$100
Building	780	€1 = $1.00 (historic rate-2020)	780
Machine	300	€1 = $1.00 (historic rate-2020)	*300*
Total assets			$1,180
Liabilities			
Total liabilities			$0
2020 ending OFCNV			$1,180

(C) *Determination of net unrecognized section 987 gain or loss*. The net unrecognized section 987 gain or loss of Business A for 2021 is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1*. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	$1,410
Less: 2020 ending OFCNV	*(1,180)*
Change in OFCNV	$230

(*2*) *Step 6*. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is $100.

Change in OFCNV	$230
Less: section 987 taxable income	*(100)*
Unrecognized section 987 gain	$130
Plus: Net accumulated unrecognized section 987 gain or loss from prior years	0
Net unrecognized section 987 gain	$130

(iii) *Operations in 2022*. The facts about Business A's operations in 2022 are the same as in *Example 3*, except that due to Business A's dollar-value LIFO method of inventory accounting, Business A's balance sheet on December 31, 2022, reflects a 2021 layer of inventory with a LIFO cost basis of €40 and a 2022 layer of inventory with a LIFO cost basis of €10.80, and Business A's COGS is €99.20.

(A) *Determination of income*. Business A's income for 2022 is computed as follows:

Item	*Amount in €*	*Translation Rate*	*Amount in $*
Sales revenue	€180	€1 = $2.50 (yearly avg. rate-2022)	$450
COGS before adjustments	99.20	€1 = $2.50 (yearly avg. rate-2022)	$248
Adjustment for cost recovery deductions (same as *Example 3*)			(60)

Item	Amount in €	Translation Rate	Amount in $
Adjustment for LIFO liquidation (none)			*0*
Adjusted COGS			$188
SG&A			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate-2020)	$10
Salaries	10	€1 = $2.50 (yearly avg. rate-2022)	*25*
Total SG&A			$35
Section 987 net income (revenue less COGS and SG&A)			$227

OFCNV-End of 2022 *Assets*	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€260.00	€1 = $3.00 (year-end spot rate-2022)	$780
Building	740.00	€1 = $1.00 (historic rate-2020)	740
Machine	240.00	€1 = $1.00 (historic rate-2020)	240
Inventory	10.80	€1 = $2.50 (historic rate-2022)	27
	40.00	€1 = $1.50 (historic rate-2021)	*60*
Total assets			$1,847
Liabilities			
Total liabilities			$0
2022 ending OFCNV			$1,847

(B) *Determination of net unrecognized section 987 gain or loss*. The net unrecognized section 987 gain of Business A for 2022 is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1*. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	$1,847
Less: 2021 ending OFCNV	*(1,410)*
Change in OFCNV	$437

(*2*) *Step 6—Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year*. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is $227.

Change in OFCNV	$437
Less: section 987 taxable income	*(227)*
Unrecognized section 987 gain 2022	$210
Plus: net accumulated unrecognized section 987 gain from prior years	130
Net unrecognized section 987 gain	$340

(iv) *Operations in 2023*. During 2023, Business A recognizes revenue of €252 from sales of finished goods. The related COGS is €140.80, reflecting a full liquidation of the 2022 inventory layer with a LIFO cost basis of $10.80 and a partial liquidation of inventory from the 2021 layer with a LIFO cost basis of $10.00. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2023 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2023, shows no liabilities and the following assets: currency of €422, the building with an adjusted basis of €720, the machine with an adjusted basis of €210, and a 2021 layer of ending inventory with a LIFO cost basis of €30, comprising raw materials and finished goods. The yearly average exchange rate for 2023 is €1 = $3.50, and the spot rate on December 31, 2023 is €1 = $4.00.

(A) *Determination of income*. Business A's income for 2023 is computed as follows:

Item	*Amount in €*	*Translation Rate*	*Amount in $*
Sales revenue	€252	€1 = $3.50 (yearly avg. rate-2023)	$882
COGS before adjustments	140.80	€1 = $3.50 (yearly avg. rate-2023)	$492.80
Adjustment for cost recovery deductions (see calculation below)			(100.00)
Adjustment for LIFO liquidation (see calculation below)			*(30.80)*
Adjusted COGS			$362.00
SG&A			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate-2020)	$10
Salaries	10	€1 = $3.50 (yearly avg. rate-2023)	35
Total SG&A			$45
Section 987 net income			$475

COGS Adjustments

Adjustment for cost recovery deductions

Depreciation Amount	*Historic Rate*	*2023 Yearly Avg. Rate*	*Difference in Translation Rates*	*Adjustment (Depreciation x Change in Rates)*
€10 (building)	1.00	3.50	(2.50)	($25)
€30 (machine)	1.00	3.50	(2.50)	*($75)*
Total adjustment for cost recovery deductions				($100)

Adjustment for LIFO liquidation

LIFO Liquidation Layer	*Historic Rate*	*2023 Yearly Avg. Rate*	*Difference in Translation Rates*	*Adjustment (Liquidated Layer x Change in Rates)*
€10.80 (2022)	2.50	3.50	(1.00)	($10.80)
€10 (2021)	1.50	3.50	(2.00)	*($20.00)*
Total adjustment for liquidation of LIFO layers				($30.80)

(B) *Determination of OFCNV*. The OFCNV of Business A for 2023 is determined under paragraph (e) of this section as follows:

OFCNV-End of 2023

Assets	*Amount in €*	*Translation Rate*	*Amount in $*
Euros	€422	€1 = $4.00 (year-end spot rate-2023)	$1,688
Building	720	€1 = $1.00 (historic rate-2020)	720
Machine	210	€1 = $1.00 (historic rate-2020)	210
Inventory	30	€1 = $1.50 (historic rate-2021)	45
Total assets			$2,663
Liabilities			
Total liabilities			$0
2023 ending OFCNV			$2,663

(C) *Determination of net unrecognized section 987 gain or loss*. The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1*. Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2023, less the OFCNV of Business A determined on the last day of 2022.

2023 ending OFCNV	$2,663
Less: 2022 ending OFCNV	*(1,847)*
Change in OFCNV	$816

(*2*) *Step 6—Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year*. Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2023, as determined above, is $475.

Change in OFCNV	$816
Less: section 987 taxable income	*(475)*
Unrecognized section 987 gain 2023	$341
Plus: net accumulated unrecognized section 987 gain from prior years	340
Net unrecognized section 987 gain	$681

§ 1.987–5 Recognition of section 987 gain or loss.

(a) *Recognition of section 987 gain or loss by the owner of a section 987 QBU*. The taxable income of an owner of a section 987 QBU shall include the owner's section 987 gain or loss recognized with respect to the section 987 QBU for the taxable year. Except as otherwise provided, for any taxable year the owner's section 987 gain or loss recognized with respect to a section 987 QBU shall equal:

(1) The owner's net unrecognized section 987 gain or loss with respect to the section 987 QBU determined under § 1.987–4 on the last day of such taxable year (or, if earlier, on the day the section 987 QBU is terminated under § 1.987–8); multiplied by

(2) The owner's remittance proportion for the taxable year, as determined under paragraph (b) of this section.

(b) *Remittance proportion*. The owner's remittance proportion with respect to a section 987 QBU for a taxable year shall equal:

(1) The remittance, as determined under paragraph (c) of this section, to the owner from the section 987 QBU for such taxable year; divided by

(2) The sum of

(A) The aggregate adjusted basis of the gross assets of the section 987 QBU as of the end of the taxable year that are reflected on its year-end balance sheet translated into the owner's functional currency as provided in § 1.987–4(e)(2) and

(B) The amount of the remittance as determined under paragraph (c) of this section.

(c) *Remittance*—(1) *Definition*. A remittance shall be determined in the owner's functional currency and shall equal the excess, if any, of:

(i) The aggregate of all amounts transferred from the section 987 QBU to the owner during the taxable year, as determined in paragraph (d) of this section; over

(ii) The aggregate of all amounts transferred from the owner to the section 987 QBU during the taxable year, as determined in paragraph (e) of this section.

(2) *Day when a remittance is determined*. An owner's remittance from a section 987 QBU shall be determined on the last day of the owner's taxable year (or, if earlier, on the day the section 987 QBU is terminated under § 1.987–8).

(3) *Termination*. A termination of a section 987 QBU as determined under § 1.987–8 is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of such termination. See § 1.987–8(e). Accordingly, the remittance proportion in the case of a termination is 1.

(d) *Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year*. For purposes of paragraph (c)(1)(i) of this section, the aggregate amount transferred from the section 987 QBU to the owner for the taxable year shall be the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under § 1.987–4(d)(2). Solely for this purpose, the amount of liabilities transferred from the owner to the section 987 QBU, as determined in the owner's functional currency under § 1.987–4(d)(5), shall be treated as a transfer of assets from the section 987 QBU to the owner in an amount equal to the amount of such liabilities.

(e) *Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year*. For purposes of paragraph (c)(1)(ii) of this section, the aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year shall be the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred, as determined in the owner's functional currency under § 1.987–4(d)(3). Solely for this purpose, the amount of liabilities transferred from the section 987 QBU to the owner determined under § 1.987–4(d)(4) shall be treated as a transfer of assets from the owner to the section 987 QBU in an amount equal to the amount of such liabilities.

(f) *Determination of owner's adjusted basis in transferred assets*—(1) *In general*. The owner's adjusted basis in an asset received in a transfer from a section 987 QBU (whether or not such transfer is made in connection with a remittance, as defined in paragraph (c) of this section) shall be determined in the owner's functional currency under the rules prescribed in paragraphs (f)(2) and (f)(3) of this section.

(2) *Marked asset*. The basis of a marked asset shall be the amount determined by translating the section 987 QBU's functional currency basis of the asset, after taking into account § 1.988–1(a)(10), into the owner's functional currency at the spot rate (as defined in § 1.987–1(c)(1)) applicable to the date of transfer.

(3) *Historic asset*. The basis of a historic asset shall be the amount determined by translating the section 987 QBU's functional currency basis of the asset, after taking into account § 1.988–1(a)(10), into the owner's functional currency at the historic rate for the asset (as defined in § 1.987–1(c)(3)).

(g) *Example*. The following example illustrates the calculation of section 987 gain or loss under this section:

Example. (i) U.S. Corp, a domestic corporation with the dollar as its functional currency, operates in the United Kingdom through Business A, a section 987 QBU with the pound as its functional currency. During 2021, the following transfers took place between U.S. Corp and Business A. On January 5, 2021, U.S. Corp transferred to Business A $300, which Business A used during the year to purchase services. On March 5, 2021, Business A transferred a machine to U.S. Corp. The pound adjusted basis of the machine when properly translated into dollars as described under § 1.987–4(d)(2)(ii)(B) and paragraph (d) of this section is $500. On November 1, 2021, Business A transferred pounds to U.S. Corp. The dollar amount of the pounds when properly translated as described under § 1.987–4(d)(2)(ii)(A) and paragraph (d) of this section is $2,300. On December 7, 2021, U.S Corp transferred a truck to Business A with an adjusted basis of $2,000.

(ii) At the end of 2021, Business A holds assets, properly translated into the owner's functional currency pursuant to § 1.987–4(e)(2), consisting of a computer with a pound adjusted basis equivalent to $500, a truck with a pound adjusted basis equivalent to $2,000, and pounds equivalent to $2,850. In addition, Business A has a pound liability entered into in 2020 with Bank A. All such assets and liabilities are reflected on the books and records of Business A. Assume that the net unrecognized section 987 gain for Business A as determined under § 1.987–4 as of the last day of 2021 is $80.

(iii) U.S. Corp's section 987 gain with respect to Business A is determined as follows:

(A) *Computation of amount of remittance*. Under paragraphs (c)(1) and (c)(2) of this section, U.S. Corp must determine the amount of the remittance for 2021 in the owner's functional currency (dollars) on the last day of 2021. The amount of the remittance for 2021 is $500, determined as follows:

Transfers from Business A to U.S. Corp in dollars:	
Machine	$500
Pounds	*2,300*
Aggregate transfers from Business A to U.S. Corp	$2,800
Transfers from U.S. Corp to Business A in dollars:	
U.S. dollars	$300
Truck	*2,000*
Aggregate transfers from U.S. Corp to Business A	$2,300
Computation of amount of remittance:	
Aggregate transfers from Business A to U.S. Corp	$2,800
Less: aggregate transfers from U.S. Corp to Business A	*(2,300)*
Total remittance	$500

(B) *Computation of section 987 QBU gross assets plus remittance*. Under paragraph (b)(2) of this section, Business A must determine the aggregate basis of its gross assets that are reflected on its year-end balance sheet translated into the owner's functional currency and must increase this amount by the amount of the remittance.

Computer	$500
Pounds	2,850
Truck	*2,000*
Aggregate gross assets	$5,350
Remittance	$500
Aggregate basis of Business A's gross assets at end of 2021, increased by amount of remittance	$5,850

(C) *Computation of remittance proportion*. Under paragraph (b) of this section, Business A must compute the remittance proportion by dividing the $500 remittance amount by the $5,850 sum of the aggregate basis of Business A's gross assets and the amount of the remittance. The resulting remittance proportion is 0.085.

(D) *Computation of section 987 gain or loss*. The amount of U.S. Corp's section 987 gain or loss that must be recognized with respect to Business A is determined under paragraph (a) of this section by multiplying the 0.085 remittance proportion by the $80 of net unrecognized section 987 gain. U.S. Corp's resulting recognized section 987 gain for 2021 is $6.80.

Par. 5 Sections 1.987–6 through 1.987–11 are added to read as follows:

* * * * *

Sec.

1.987–6 Character and source of section 987 gain or loss.

1.987–7 Section 987 aggregate partnerships.

1.987–8 Termination of a section 987 QBU.

1.987–9 Recordkeeping requirements.

1.987–10 Transition rules.

1.987–11 Effective/applicability date.

* * * * *

§ 1.987–6 Character and source of section 987 gain or loss.

(a) *Ordinary income or loss.* Section 987 gain or loss is ordinary income or loss for Federal income tax purposes.

(b) *Character and source of section 987 gain or loss*—(1) *In general*. With respect to each section 987 QBU, the owner must determine the character and source of section 987 gain or loss in the year of a remittance under the rules of this paragraph (b) for all purposes of the Internal Revenue Code, including sections 904(d), 907, and 954.

(2) *Method required to characterize and source section 987 gain or loss*. The owner must use the asset method set forth in § 1.861–9T(g) to characterize and source section 987 gain or loss. In applying the asset method, the owner must take into account only the assets of the section 987 QBU and must consistently determine the value of the assets on the basis of either the tax book value or the fair market value of the assets. The modified gross income method described in § 1.861–9T(j) cannot be used.

(3) *Coordination with section 954*. Solely for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D), section 987 gain or loss that is characterized pursuant to paragraph (b)(2) of this section by reference to assets that give rise to subpart F income shall be treated as foreign currency gain or foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation.

(c) *Examples*. The following examples illustrate the application of this section.

Example 1. CFC is a controlled foreign corporation as defined in section 957 with the Swiss franc (Sf) as its functional currency. CFC is the owner of Business A, a section 987 QBU that has the euro as its functional currency. For the year 2021, CFC recognizes section 987 gain of Sf10,000 under § 1.987–5. Applying the rules of this section, Business A has average total assets of Sf1,000,000, which generate income as follows: Sf750,000 of assets that generate foreign source general limitation income under section 904(d)(1)(A), none of which is subpart F income under section 952; and Sf250,000 of assets that generate foreign source passive income under section 904(d)(1)(B), all of which is subpart F income. Under paragraph (b) of this section, Sf7,500 (Sf750,000/Sf1,000,000 x Sf10,000) of the section 987 gain will be characterized as foreign source general limitation income that is not subpart F income under section 952, and Sf2,500 (Sf250,000/Sf1,000,000 x Sf10,000) will be characterized as foreign source passive income that is characterized as foreign personal holding company income under section 954(c)(1)(D). All of the section 987 gain is treated as ordinary income.

Example 2. The facts are the same as in *Example 1* except that: (a) CFC recognizes section 987 loss of Sf40,000, Sf10,000 of which is characterized under paragraph (b) of this section by reference to assets that give rise to subpart F income; and (b) CFC otherwise has Sf12,000 of net foreign currency gain determined under § 1.954–2(g) that is taken into account in determining the excess of foreign currency gain over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Under paragraph (b)(3) of this section, the Sf10,000 section 987 loss characterized by reference to assets that give rise to subpart F income is treated as foreign currency loss attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation for purposes of determining the excess of foreign currency gains over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D). Accordingly, CFC will aggregate the Sf10,000 section 987 loss with the Sf12,000 net foreign currency gain and will have Sf2,000 of net foreign currency gain characterized as foreign personal holding company income under section 954(c)(1)(D).

§ 1.987–7 Section 987 aggregate partnerships.

(a) *In general.* This section provides rules for determining an owner's share of the assets and liabilities of an eligible QBU that is owned indirectly, as described in § 1.987–1(b)(4)(ii), through a section 987 aggregate partnership.

(b) [Reserved].

(c) *Coordination with subchapter K.* [Reserved].

§ 1.987–8 Termination of a section 987 QBU.

(a) *Scope*. This section provides rules regarding the termination of a section 987 QBU. Paragraph (b) of this section provides general rules for determining when a termination occurs. Paragraph (c) of this section provides exceptions to the general termination rules for certain transactions described in section 381(a). Paragraph (e) of this section describes certain effects of terminations. Paragraph (f) of this section contains examples that illustrate the principles of this section.

(b) *In general*. Except as provided in paragraph (c) of this section, a section 987 QBU terminates if the conditions described in one of paragraphs (b)(1) through (4) is satisfied.

(1) *Trade or business ceases*. A section 987 QBU ceases its trade or business. When a section 987 QBU ceases its trade or business is determined based on all the facts and circumstances, provided that an owner may continue to treat a section 987 QBU as a section 987 QBU for a reasonable period during the winding up of such trade or business, which period may in no event exceed two years from the date on which such QBU ceases its activities carried on for profit.

(2) *Substantially all assets transferred*. The section 987 QBU transfers substantially all (within the meaning of section 368(a)(1)(C)) of its assets to its owner. For purposes of this paragraph (b)(2), the amount of assets transferred from the section 987 QBU to its owner as a result of a transaction shall be reduced by the amount of assets transferred from the owner to the section 987 QBU pursuant to the same transaction. See Examples 2, 5, and 6 in paragraph (f) of this section.

(3) *Owner no longer a CFC*. A foreign corporation that is a controlled foreign corporation (as defined in section 957) that is the owner of a section 987 QBU ceases to be a controlled foreign corporation as a result of a transaction or series of transactions after which persons that were related to the corporation within the meaning of section 267(b) immediately before the transaction or series of transactions collectively own sufficient interests in the corporation such that the corporation would continue to be considered a

controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b).

(4) *Owner ceases to exist*. The owner of the section 987 QBU ceases to exist (including in connection with a transaction described in section 381(a)).

(c) *Transactions described in section 381(a)*—(1) *Liquidations*. Notwithstanding paragraph (b) of this section, a termination does not occur when the owner of a section 987 QBU ceases to exist in a liquidation described in section 332, except in the following cases:

(i) The distributor is a domestic corporation and the distributee is a foreign corporation.

(ii) The distributor is a foreign corporation and the distributee is a domestic corporation.

(iii) The distributor and the distributee are both foreign corporations and the functional currency of the distributee is the same as the functional currency of the distributor's section 987 QBU.

(2) *Reorganizations*. Notwithstanding paragraph (b) of this section, a termination does not occur when the owner of the section 987 QBU ceases to exist in a reorganization described in section 381(a)(2), except in the following cases:

(i) The transferor is a domestic corporation and the acquiring corporation is a foreign corporation.

(ii) The transferor is a foreign corporation and the acquiring corporation is a domestic corporation.

(iii) The transferor is a controlled foreign corporation immediately before the transfer, the acquiring corporation is a foreign corporation that is not a controlled foreign corporation immediately after the transfer, and the acquiring corporation was related to the transferor within the meaning of section 267(b) immediately before the transfer.

(iv) The transferor and the acquiring corporation are foreign corporations and the functional currency of the acquiring corporation is the same as the functional currency of the transferor's section 987 QBU.

(d) [Reserved].

(e) *Effect of terminations*. A termination of a section 987 QBU as determined in this section is treated as a remittance of all the gross assets of the section 987 QBU to its owner immediately before the section 987 QBU terminates. Thus, except as otherwise provided in these regulations under section 987, a termination results in the recognition of any net unrecognized section 987 gain or loss of the section 987 QBU. See § 1.987–5(c)(3).

(f) *Examples*. The following examples illustrate the principles of this section. Except as otherwise provided, U.S. Corp is a domestic corporation that has the U.S. dollar as its functional currency, and Business A is a section 987 QBU.

Example 1. Cessation of operations. (i) *Facts*. U.S. Corp is the owner of Business A , a sales office of U.S. Corp in Country X. Business A ceases sales activities on December 31, 2021. During 2022, Business A sells all of the assets used in its sales activities and winds up its business, settling outstanding accounts.

(ii) *Analysis*. Business A's trade or business ceases on December 31, 2021. The cessation of Business A's trade or business causes a termination of the Business A section 987 QBU under paragraph (b)(1) of this section on December 31, 2021, unless U.S. Corp chooses to continue to treat Business A as a section 987 QBU until completion of the wind-up activities in 2022. If U.S. Corp chooses to continue to treat Business A as a section 987 QBU during the wind-up of Business A, Business A section 987 QBU would terminate under paragraph (b)(1) of this section upon completion of the wind-up in 2022.

Example 2. Transfer of a section 987 QBU to a member of a consolidated group. (i) *Facts*. U.S. Corp, the owner of Business A, transfers all the assets and liabilities of Business A to DS, a domestic corporation all of the stock of which is owned by U.S. Corp, in a transaction qualifying under section 351. U.S. Corp and DS are members of the same consolidated group.

(ii) *Analysis*. Pursuant to § 1.987–2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A for DS stock in a section 351 transaction, Business A is treated as transferring its assets and liabilities to U.S. Corp immediately before the transfer by U.S. Corp of the assets and liabilities to DS. Because a section 351 transaction is not a transaction described in section 381(a), the transfer of all of the assets of Business A to U.S. Corp causes a termination of the Business A section 987 QBU under paragraph (b)(2) of this section.

Example 3. Cessation of controlled foreign corporation status. (i) *Facts*. Foreign parent (FP) is a foreign corporation that owns all the stock of U.S. Corp, a domestic corporation. U.S. Corp owns all of the stock of FC, a controlled foreign corporation as defined in section 957. FC is the owner of Business A. FP contributes cash to FC in exchange for FC stock representing 60 percent of the voting power and value of all FC stock. FC no longer constitutes a controlled foreign corporation after the capital contribution.

(ii) *Analysis*. Because FC ceases to qualify as a controlled foreign corporation as a result of a transaction after which persons that were related to FC within the meaning of section 267(b) immediately before the transaction collectively own sufficient interests in FC such that the FC would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b), the Business A section 987 QBU terminates pursuant to paragraph (b)(3) of this section.

Example 4. Section 332 liquidation. (i) *Facts*. U.S. Corp owns all of the stock of FC, a foreign corporation. FC is the owner of Business A. Pursuant to a liquidation described in section 332, FC transfers all of its assets and liabilities to U.S. Corp.

(ii) *Analysis*. FC's liquidation causes a termination of the Business A section 987 QBU as provided in paragraph (b)(4) of this section because FC ceases to exist as a result of the liquidation. The exception for certain section 332 liquidations provided under paragraph (c)(1) of this section does not apply because U.S. Corp is a domestic corporation and FC is a foreign corporation. See paragraph (c)(1)(ii) of this section.

Example 5. Transfers to and from a section 987 QBU pursuant to the same transaction. (i) *Facts*. U.S. Corp owns 100 percent of DC1 and DC2, each a domestic corporation. DC1 owns Entity A, a DE that conducts a business (Business A) in Country X that constitutes a section 987 QBU of DC1. DC2 subsequently contributes property to Entity A in exchange for a 95 percent interest in Entity A. The property DC2 contributes to Entity A is used in the business conducted by Business A and is reflected on its books and records as provided under § 1.987–2(b).

(ii) *Analysis*. (A) For general Federal income tax purposes, Entity A is converted to a partnership when DC2 contributes property to Entity A in exchange for a 95 percent interest in Entity A. DC2's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. DC1 is treated as contributing all of Business A to the partnership in exchange for a partnership interest. See Rev. Rul. 99–5 (situation 2), (1999–1 CB 434) and § 601.601(d)(2) of this chapter. For purposes of this section, these deemed transactions are not taken into account. See § 1.987–2(c) and § 1.987–2(c)(10), Example 9.

(B) Under § 1.987–1(b)(5)(i), Entity A is converted to a section 987 aggregate partnership when DC2 contributes property to Entity A in exchange for a 95 percent interest in Entity A because DC1 and DC2 own all the interests in partnership capital and profits, DC1 and DC2 are related within the meaning of section 267(b), and the requirements of § 1.987–1(b)(5)(i)(B) are satisfied. Because DC2 is a partner in a section 987 aggregate partnership that owns Business A and because DC2 and Business A have different functional currencies, DC2's portion of the Business A assets constitutes a section 987 QBU of DC2.

(C) As a result of the conversion of Entity A to a partnership, DC2 acquires an allocable share of 95 percent of the assets of Business A, as determined under § 1.987–7. Accordingly, under § 1.987–2(c)(5), DC2 is treated as contributing 95 percent of its contributed property to its Business A section 987 QBU. In addition, DC2 is treated as transferring 5 percent of the contributed property to DC1, and DC1 is subsequently treated as transferring that property to DC1's Business A section 987 QBU. In addition, 95 percent of the original (pre-conversion) assets of Business A cease being reflected on the books and records of DC1's section 987 QBU. Under § 1.987–2(b)(5), these amounts are treated as if they are transferred from DC1's section 987 QBU to DC1, and DC1 is treated as transferring these assets to DC2. DC2 is subsequently treated as transferring these assets to DC2's Business A section 987 QBU. The other 5 percent of the original (pre-conversion) assets are treated as remaining on the books and records of DC1's section 987 QBU and are not deemed to be transferred.

(D) For purposes of determining whether substantially all the assets of Business A were transferred from DC1's section 987 QBU as provided under paragraph (b)(2) of this section, the amount of assets transferred from Business A to DC1 under § 1.987–2(c) (95 percent of the assets held by Business A before the contribution by DC2) must be reduced by the 5 percent of the assets contributed by DC2, which were treated as transferred from DC2 to DC1 and subsequently transferred from DC1 to its Business A section 987 QBU, as a result of the formation of the section 987 aggregate partnership. Accordingly, the amount of assets transferred from DC1's section 987 QBU for purposes of paragraph (b)(2) of this section is equal to 95 percent of the original (pre-conversion) assets minus 5 percent of DC2's contributed assets.

Example 6. Deemed transfers to a CFC upon a check-the-box election. (i) *Facts*. In 2021, U.S. Corp forms an entity in a foreign country, Entity A. Entity A owns Business A, which has the pound as its functional currency. Entity A forms Entity B in another foreign country. Entity B owns Business B, a section 987 QBU that has the euro as its functional currency. At the time of formation, Entity A and Entity B elect to be DEs. In 2026, Entity A files an election on Form 8832 to be classified as a corporation under § 301.7701–3(g)(1)(iv) and becomes a CFC (FC) owned directly by U.S. Corp. FC has the pound as its functional currency.

(ii) *Analysis*. (A) Under § 1.987–1(b)(4)(i), U.S. Corp is the owner of Business A and Business B. In 2026, when Entity A elects to be classified as a corporation, U.S. Corp is deemed to contribute the assets and liabilities of Business A and Business B to FC under section 351 in exchange for FC stock. Pursuant to § 1.987–2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A and Business B for FC stock in a section 351 transaction, Business A and Business B are each treated as transferring their assets and liabilities to U.S. Corp immediately before U.S. Corp's transfer of such assets and liabilities to FC. The transfer of assets from Business A and Business B to U.S. Corp causes terminations of those section 987 QBUs under paragraph (b)(2) of this section. The assets and liabilities of Business A and Business B are now owned by FC, but because FC and Business A have the same functional currency, only Business B qualifies as a section 987 QBU to which section 987 applies.

(B) Terminations also would have occurred in 2026 if U.S. Corp had contributed Entity A and Entity B to an existing foreign corporation owned by U.S. Corp or to a newly created foreign corporation owned by U.S. Corp pursuant to a section 351 exchange because the transfer of all of the assets of Business A and Business B would cause terminations of those section 987 QBUs under paragraph (b)(2) of this section.

Example 7. Sale of a section 987 QBU to a member of a consolidated group. (i) *Facts*. U.S. Corp, the owner of Business A, sells all of the assets and liabilities of Business A to DS, a domestic corporation, in exchange for cash. U.S. Corp and DS are members of the same consolidated group. The cash received on the sale is recorded on the books of U.S. Corp.

(ii) *Analysis*. Pursuant to § 1.987–2(c)(2)(i) and (ii), Business A is treated as transferring all of its assets and liabilities to U.S. Corp immediately before the sale by U.S. Corp to DS. As a result of this deemed transfer from Business A to U.S. Corp, the Business A section 987 QBU terminates under paragraph (b)(2) of this section.

§ 1.987–9 Recordkeeping requirements.

(a) *In general*. A taxpayer that is an owner of a section 987 QBU shall keep a copy of each election made by the taxpayer in accordance with the rules of § 1.987–1(g)(3) (if not required to be made on a form published by the Commissioner regarding section 987) and such reasonable records as are sufficient to establish the section 987 QBU's taxable income or loss and section 987 gain or loss.

(b) *Supplemental information*. An owner's obligation to maintain records under section 6001 and paragraph (a) of this section is not satisfied unless the following information is maintained in such records with respect to each section 987 QBU:

(1) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU in the functional currency of the section 987 QBU.

(2) The amount of assets and liabilities attributed to the section 987 QBU in the functional currency of the section 987 QBU.

(3) The exchange rates used to translate items of income, gain, deduction, or loss of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which such convention is determined.

(4) The exchange rates used to translate the assets and liabilities of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which such convention is determined.

(5) The amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU translated into the functional currency of the owner.

(6) The amount of assets and liabilities attributed to the section 987 QBU translated into the functional currency of the owner.

(7) The amount of assets and liabilities transferred by the owner to the section 987 QBU determined in the functional currency of the owner.

(8) The amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner.

(9) The amount of the unrecognized section 987 gain or loss for the taxable year.

(10) The amount of the net accumulated unrecognized section 987 gain or loss at the close of the taxable year.

(11) If a remittance is made, the computations determined under § 1.861–9T(g) for purposes of sourcing and characterizing the remittance under § 1.987–5.

(12) The transition information required to be determined under § 1.987–10(e).

(c) *Retention of records*. The records required by this section, or records that support the information required on a form published by the Commissioner regarding section 987, must be maintained and kept at all times available for inspection by the Internal Revenue Service for so long as the contents thereof may become relevant in the administration of the Internal Revenue Code.

(d) *Information on a dedicated section 987 form*. The requirements of paragraph (b) of this section shall be satisfied if the taxpayer provides the specific information required on a form published by the Commissioner for this purpose.

§ 1.987–10 Transition rules.

(a) *Scope*. These transition rules shall apply to any taxpayer that is an owner of a section 987 QBU pursuant to § 1.987–1(b)(4) on the transition date (as defined in § 1.987–11(c)). Except as provided in paragraph (c) of this section, a taxpayer to which this section applies must transition from the method previously used to comply with section 987 (the "prior section

987 method") to the method prescribed by these regulations pursuant to the fresh start transition method set forth in paragraph (b) of this section.

(b) *Fresh start transition method*—(1) *In general*. Pursuant to the fresh start transition method, and solely for purposes of this section, all section 987 QBUs of a taxpayer, other than section 987 QBUs subject to paragraph (c) of this section, are deemed to terminate on the day before the transition date. No section 987 gain or loss is determined or recognized as a result of the deemed termination. The owner of a section 987 QBU that is deemed to terminate under this section is treated as having transferred all of the assets and liabilities attributable to such QBU to a new section 987 QBU on the transition date. This deemed transfer of assets and liabilities is taken into account only for purposes of transitioning to these regulations under section 987 and shall not be taken into account in determining the amounts transferred from the owner to the section 987 QBU during the taxable year for purposes of § 1.987–5(c)(1)(ii).

(2) *Application of § 1.987–4*. For purposes of applying § 1.987–4 with respect to a section 987 QBU described in paragraph (b)(1) of this section for the taxable year beginning on the transition date, the amount of assets and liabilities deemed transferred from the owner to the section 987 QBU on the transition date pursuant to paragraph (b)(1) of this section shall be determined by translating such assets and liabilities (without regard to whether the asset or liability is a marked item or a historic item) at the historic rate as determined under paragraph (b)(3) of this section.

(3) *Determination of historic rate*. For purposes of applying these regulations with respect to a section 987 QBU described in paragraph (b)(1) of this section for taxable years beginning on or after the transition date, the historic rate (as defined in § 1.987–1(c)(3)) for an asset or liability deemed transferred under paragraph (b)(1) of this section from an owner to the section 987 QBU on the transition date shall be the historic rate under § 1.987–1(c)(3) determined by reference to the date the assets were acquired or liabilities entered into or assumed by the section 987 QBU deemed terminated (that is, without regard to the deemed termination or transfer described in paragraph (b)(1) of this section). However, if the owner is not able to determine reliably the historic rate for a particular asset or liability, then the historic rate must be determined based on reasonable assumptions (for example, assumptions about turnover and aging of accounts receivable), consistently applied.

(4) *Example*. The provisions of this paragraph (b) are illustrated by the following example. Exchange rate assumptions used in the example are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the effect of depreciation is not taken into account for purposes of this example.

Example. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns Business A, a U.K. branch with the pound as its functional currency. Business A was formed on January 1, year 1. U.S. Corp uses the method prescribed in the 1991 proposed section 987 regulations to determine the section 987 gain or loss of Business A. U.S. Corp contributed £6,000 to Business A on January 1, year 1. On the same day, Business A bought a truck for £4,000 and a computer for £1,000. Business A had profits determined under § 1.987–1(b)(1)(i) through (iii) of the 1991 proposed section 987 regulations of £250 in each of year 1, year 2, and year 3, and the yearly average exchange rate was used in each of those years to translate Business A's profits under the 1991 proposed section 987 regulations. The yearly average exchange rate was £1 = $1.10 in year 1, £1 = $1.20 in year 2, and £1 = $1.30 in year 3. Business A incurred a £50 loss in each of year 4 and year 5. Business A made no remittances to U.S. Corp in any year.

(ii) On January 1, year 5, Business A transitions to the method provided in these regulations pursuant to the fresh start transition method described in paragraph (b) of this section. Pursuant to paragraph (b)(1) of this section, Business A is deemed to terminate on December 31, year 4. However, no section 987 gain or loss is determined or recognized as a result of the deemed termination. Pursuant to paragraph (b)(2) of this section, for purposes of applying § 1.987–4 with respect to Business A for year 5, the amount of assets and liabilities transferred from U.S. Corp to Business A on the transition date shall be determined by translating all of Business A's assets at the historic rates for those assets as determined under § 1.987–1(c)(3) and paragraph (b)(3) of this section. Because U.S. Corp is not able to determine reliably the historic rate for the pound currency it is deemed to transfer to Business A, U.S. Corp determines the historic rate for these pounds based on a last-in, first-out cash flow assumption. Thus, it is assumed that the £50 loss in each of year 4 and year 5 first reduces the £250 earned in year 3. Accordingly, for purposes of determining the amount of assets and liabilities deemed transferred from U.S. Corp to Business A on January 1, year 5, U.S. Corp translates Business A's assets and liabilities as follows:

Assets	*Amount in £*	*Translation Rate*	*Amount in $*
Pounds	£1,000	£1 = $1.10 (yearly average rate-year 1)	$1,100
Pounds	250	£1 = $1.10 (yearly average rate-year 1)	275
Pounds	250	£1 = $1.20 (yearly average rate-year 2)	300
Pounds	150	£1 = $1.30 (yearly average rate-year 3)	195
Truck	4,000	£1 = $1.10 (yearly average rate-year 1)	4,400
Computer	1,000	£1 = $1.10 (yearly average rate-year 1)	*1,100*
Total assets			$7,370
Liabilities			
Total liabilities			$0

(c) *Transition of section 987 QBUs that applied the method set forth in the 2006 proposed section 987 regulations*.—(1) *In general*. If, with respect to a particular section 987 QBU, a taxpayer's prior section 987 method was based on a reasonable application of the method described in the 2006 proposed section 987 regulations (REG–208270–86, 71 FR 52876), then the taxpayer shall apply these regulations under section 987 with respect to such section 987 QBU without regard to paragraph (b) of this section.

(2) *Application of § 1.987–4*. For purposes of applying § 1.987–4 with respect to a section 987 QBU described in paragraph (c)(1) for the taxable year beginning on the transition date, the owner functional currency net value of the section 987 QBU on the last day of the preceding taxable year under § 1.987–4(d)(1)(B) shall be the amount that was determined under § 1.987–4(d)(1)(A) of the 2006 proposed section 987 regulations for the preceding taxable year. Additionally, for purposes of applying § 1.987–4 with respect to a section 987 QBU described in paragraph (c)(1) for all taxable years that end after the transition date, the section 987 QBU's net unrecognized section 987 gain or loss for all prior taxable years under § 1.987–4(c) shall take into account the aggregate of the amounts determined under § 1.987–4(d) of the 2006 proposed section 987 regulations for taxable years for which the taxpayer applied the 2006 proposed section 987 regulations, reduced by the amounts taken into account under § 1.987–5 of the 2006 proposed section 987 regulations upon a remittance for all such prior taxable years.

(3) *Use of prior historic rate*. For purposes of applying these regulations under section 987 with respect to historic items (as defined in § 1.987–1(e)), other than inventory, that are reflected on the balance sheet of the section 987 QBU on the transition date, a taxpayer may use the same historic exchange rates as were used under the taxpayer's application of the 2006 proposed section 987 regulations in place of the historic rates that otherwise would be determined under § 1.987–1(c)(3), provided that, for all taxable years that end after the transition date, the taxpayer does so with respect to all historic items (other than inventory) that are reflected on the balance sheet of the section 987 QBU on the transition date.

(4) *Example*. The provisions of this paragraph (c) are illustrated by the following example. Exchange rate assumptions used in the example are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the effect of depreciation is not taken into account for purposes of this example.

Example. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns Business A, a U.K. branch with the pound as its functional currency. Business A was formed on January 1, year 1. U.S. Corp uses a reasonable application of the method described in the 2006 proposed section 987 regulations to determine the section 987 gain or loss of Business A. On January 1, year 5, Business A transitions to the method provided in these regulations pursuant to the method described in this paragraph (c). Business A's opening balance sheet on January 1, year 5, includes pounds, a truck acquired in year 2, inventory accounted for under the FIFO method, and no liabilities. These assets remain on the balance sheet on December 31, year 5.

(ii) Pursuant to paragraph (c)(3) of this section, U.S. Corp chooses to use the same historic exchange rates as were used under its application of the 2006 proposed regulations in place of the historic rates prescribed under § 1.987–1(c)(3) for purposes of applying these regulations with respect to historic items (other than inventory) held on the transition date.

(iii) The pounds are marked items under § 1.987–1(d). Because the pounds are marked items, for purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to § 1.987–4(e), the pounds are translated into dollars using the spot rate (as defined in § 1.987–1(c)(1)) applicable to the last day of year 5.

(iv) The truck held on Business A's balance sheet on January 1, year 5, is a historic item under § 1.987–1(e). For purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to § 1.987–4(e), the basis of the truck is translated into dollars using the spot rate on the day the truck was acquired in year 2, as determined under § 1.987–1(c)(3) of the 2006 proposed section 987 regulations. If U.S. Corp had not chosen pursuant to paragraph (c)(3) of this section to use the same historic exchange rates as were used under its application of the 2006 proposed regulations, the basis of the truck would have been translated into dollars using the historic rate described in § 1.987–1(c)(3), which is the yearly average exchange rate for year 5.

(v) The inventory held on Business A's balance sheet on January 1, year 5, is a historic item under § 1.987–1(e). For purposes of determining the owner functional currency net value of Business A on the last day of year 5 pursuant to § 1.987–4(e), the FIFO cost basis of the inventory is translated into dollars using the historic rate, which pursuant to § 1.987–1(c)(3)(i)(B) is the yearly average exchange rate for year 5.

(vi) Pursuant to paragraph (c)(3) of this section, for purposes of applying § 1.987–4 with respect to Business A for year 5, the owner functional currency net value of Business A on the last day of year 4 under § 1.987–4(d)(1)(B) is the amount that was determined under § 1.987–4(d)(1)(A) of the 2006 proposed section 987 regulations for year 4. Additionally, Business A's net unrecognized section 987 gain or loss for all prior years under § 1.987–4(c) shall take into account the aggregate of the amounts determined under § 1.987–4(d) of the 2006 proposed section 987 regulations for year 1 through year 4, reduced by the amounts taken into account under § 1.987–5 of the 2006 proposed section 987 regulations upon a remittance for all such prior taxable years.

(d) *Adjustments to avoid double counting*. If a difference between the treatment of any item under these regulations and the treatment of the item under the taxpayer's prior section 987 method would result in income, gain, deduction or loss being taken into account more than once, then the net unrecognized section 987 gain or loss of the section 987 QBU, as determined under § 1.987–4(b) for the first taxable year for which these regulations apply, shall be adjusted to account for the difference.

(e) *Reporting*—(1) *In general*. Except as otherwise provided in this paragraph (e), the taxpayer must attach a statement titled "Section 987 Transition Information" to its timely filed return for the first taxable year to which these regulations under section 987 apply providing the following information:

(i) A description of each section 987 QBU to which these rules apply, the section 987 QBU's owner, the section 987 QBU's principal place of business, and a description of the prior section 987 method used by the taxpayer to determine section 987 gain or loss with respect to the section 987 QBU.

(ii) Any assumptions used by the taxpayer for determining the exchange rates used to translate the amount of assets and liabilities transferred to the section 987 QBU on the transition date, as provided in paragraph (b)(3) of this section.

(iii) With respect to each section 987 QBU subject to paragraph (c) of this section, a statement regarding whether historic items (as defined in § 1.987–1(c)(3)) are translated pursuant to paragraph (c)(2) of this section at the same historic rates as were used under the taxpayer's application of the 2006 proposed regulations or at the historic rates determined under § 1.987–1(c)(3).

(iv) With respect to each section 987 QBU with respect to which an adjustment is made pursuant to paragraph (d) of this section, a description of the adjustment and the basis for the computation of such adjustments.

(2) *Attachments not required where information is reported on a form*. Paragraph (e) of this section shall not apply to

the extent the information described in such paragraph is required to be reported on a form published by the Commissioner.

§ 1.987–11 Effective/applicability date.

(a) *In general*. Except as otherwise provided in this section, §§ 1.987–1 through 1.987–10 shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016.

(b) *Application of these regulations to taxable years beginning after* December 7, 2016. A taxpayer may apply these regulations under section 987 to taxable years beginning after December 7, 2016, provided the taxpayer consistently applies these regulations to such taxable years with respect to all section 987 QBUs directly or indirectly owned by the taxpayer on the transition date (as defined in paragraph (b)(2) of this section) as well as all section 987 QBUs directly or indirectly owned on the transition date by members that file a consolidated return with the taxpayer or by any controlled foreign corporation, as defined in section 957, in which a member owns more than 50 percent of the voting power or stock value, as determined under section 958(a).

(c) *Transition date*. The transition date is the first day of the first taxable year to which these regulations under section 987 are applicable with respect to a taxpayer under this section.

Par. 6. Section 1.988–0 is amended by adding an entry for § 1.988–1(a)(4).

§ 1.988–0 Taxation of gain or loss from a section 988 transaction; Table of Contents.

* * * * *

§ 1.988–1 Certain definitions and special rules.

(a) * * *
(4) Treatment of assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU.
* * * * *

Par. 7. Section 1.988–1 is amended by:

1. Adding paragraph (a)(4).
2. Revising paragraph (a)(10)(ii).
3. Adding two sentences to the end of paragraph (i).

The additions and revision read as follows:

§ 1.988–1 Certain definitions and special rules.

(a) * * *

(4) *Treatment of assets and liabilities of a section 987 aggregate partnership or DE that are not attributed to an eligible QBU*—(i) *Scope*. This paragraph (a)(4) applies to assets and liabilities of a section 987 aggregate partnership as defined in § 1.987–1(b)(5), or of an entity disregarded as an entity separate from its owner for Federal income tax purposes (DE), that are not attributable to an eligible QBU as defined in § 1.987–1(b)(3).

(ii) *Section 987 Aggregate Partnerships*. For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a section 987 aggregate partnership, the owners of the section 987 aggregate partnership (within the meaning of § 1.987–1(b)(4)) shall be treated as owning their share of such assets and liabilities. Section 1.987–7(b) shall apply for purposes of determining an owner's share of such assets or liabilities.

(iii) *Disregarded entities*. For purposes of applying section 988 and the applicable regulations to transactions involving assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a DE, the owner of the DE (within the meaning of § 1.987–1(b)(4)) shall be treated as owning all such assets and liabilities.

(iv) *Example*. The following example illustrates the application of paragraph (a)(4) of this section:

Example. *Liability held through a section 987 aggregate partnership*. (i) *Facts*. P, a foreign partnership, has two equal partners, X and Y. X is a domestic corporation with the dollar as its functional currency. Y is a foreign corporation wholly owned by X that has the yen as its functional currency. P is a section 987 aggregate partnership. On January 1, 2021, P borrowed yen and issued a note to the lender that obligated P to pay interest and repay principal to the lender in yen. Also on January 1, 2021, P used the yen it borrowed from the lender to acquire all of the stock of F, a foreign corporation, from an unrelated person. P also holds an eligible QBU (within the meaning of § 1.987–1(b)(3)) that has the yen as its functional currency. P maintains one set of books and records. The assets and liabilities of the eligible QBU are reflected on the books and records of P as provided under § 1.987–2(b). The F stock held by P, and the yen liability incurred to acquire the F stock, are also recorded on the books and records of P but, pursuant to § 1.987–2(b)(2)(i), are not considered to be reflected on the books and records of the eligible QBU for purposes of section 987.

(ii) *Analysis*. X's portion of the assets and liabilities of the eligible QBU owned by P is a section 987 QBU. Y's portion of the assets and liabilities of the eligible QBU owned by P is not a section 987 QBU because Y and the eligible QBU have the same functional currency. Because the F stock and yen-denominated liability incurred to acquire such stock are not considered reflected on the books and records of the eligible QBU, they are not subject to section 987. In addition, because the F stock and the yen-denominated liability incurred to acquire such stock are held by P (but not attributable to P's eligible QBU), X and Y are treated as owning their respective shares of such stock and liability pursuant to § 1.988–1(a)(4)(ii) for purposes of applying section 988. As a result, P's becoming the obligor on the portion of the yen-denominated note that is treated as an obligation of X is a section 988 transaction pursuant to paragraphs (a)(1)(ii), (a)(2)(ii) and (a)(3) of this section. Similarly, the dispositions of yen to make payments of interest and principal on the liability, to the extent such yen are treated as owned by X under paragraph (a)(4)(ii) of this section, are section 988 transactions under paragraphs (a)(1)(i) and (a)(3) of this section. To the extent the yen are treated as owned by the eligible QBU, see § 1.987–2(c) for the treatment of the payment of yen as a transfer from the eligible QBU to X. P's becoming the obligor on Y's portion of the yen-denominated note, and Y's portion of the yen disposed of in connection with payments on such note, are not section 988 transactions because Y has the yen as its functional currency.

* * * * *

(10) * * *

(ii) *Certain intra-taxpayer transfers of section 988 transactions that result in the recognition of section 988 gain or loss*—(A) *In general*. Exchange gain or loss with respect to nonfunctional currency or any item described in paragraph (a)(2) of this section entered into with another taxpayer shall be realized upon a transfer (as defined under § 1.987–2(c)) of such currency or item from an owner to a section 987 QBU or from a section 987 QBU to an owner if as a result of such transfer —

(*1*) The currency or item loses its character as nonfunctional currency or as an item described in paragraph (a)(2) of this section; or

(*2*) The source of the exchange gain or loss could be altered absent the application of paragraph (a)(10)(ii)(B) of this section.

(B) *Computation of exchange gain or loss*. Exchange gain or loss described in section (a)(10)(ii)(A) of this section shall be computed in accordance with § 1.988–2 (without regard to § 1.988–2(b)(8)) as if the nonfunctional currency or item described in paragraph (a)(2) of this section had been sold or otherwise transferred at fair market value between unrelated taxpayers. For purposes of the preceding sentence, a taxpayer must use a translation rate that is consistent with the translation conventions of the section 987 QBU to or from which, as the case may be, the item is being transferred. In the case of a gain or loss incurred in a transaction described in this paragraph (a)(10)(ii) that does not have a significant business purpose, the Commissioner may defer such gain or loss.

* * * * *

(i) * * * Generally, the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

Par. 8. Section 1.988–4 is amended by revising paragraph (b)(2) to read as follows:

§ 1.988–4 Source of gain or loss realized on a section 988 transfer

* * * * *

(b) * * *

(2) *Proper reflection on the books of the taxpayer or qualified business unit*—(i) *In general*. For purposes of paragraph (b)(1) of this section, the principles of § 1.987–2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books and records of a qualified business unit.

(ii) *Effective/applicability date*. Generally, paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then paragraph (b)(2)(i) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

* * * * *

Par. 9. Section 1.989(a)–1 is amended by revising paragraph (b)(2)(i) and adding paragraphs (b)(4) and (d)(3) and (4) to read as follows:

§ 1.989(a)–1 Definition of a qualified business unit.

(b) * * *

(2) * * *

(i) *Persons*—(A) *Corporations*. A corporation is a QBU.

(B) *Individuals*. An individual is not a QBU.

(C) *Partnerships*. A partnership, other than a section 987 aggregate partnership as defined in § 1.987–1(b)(5), is a QBU.

(D) *Trusts and estates*. A trust or estate is a QBU of a beneficiary.

* * * * *

(4) *Effective/applicability date*. Generally, the revisions to paragraph (b)(2)(i) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then the effective date of the revisions to paragraph (b)(2)(i) of this section with respect to the taxpayer shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

* * * * *

(d) * * *

(3) *Proper reflection on the books of the taxpayer or qualified business unit*. The principles of § 1.987–2(b) shall apply in determining whether an asset, liability, or item of income or expense is reflected on the books of a qualified business unit (and therefore is attributable to such unit).

(4) *Effective/applicability date*. Generally, the revisions to paragraph (d)(3) of this section shall apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then the revisions to paragraph (b)(2)(i) of this section shall apply with respect to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

* * * * *

§ 1.989(c)–1 [Removed]

Par. 10. Section 1.989(c)–1 is removed.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB Control No.
* * * * *	
1.987-1	1545-2265
1.987-3	1545-2265
1.987-9	1545-2265
1.987-10	1545-2265
* * * * *	

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 14, 2016

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 7, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 8, 2016, 81 F.R. 88806)

T.D. 9795

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Recognition and Deferral of Section 987 Gain or Loss

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations under section 987 of the Internal Revenue Code (Code) relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a qualified business unit (QBU) in connection with certain QBU terminations and certain other transactions involving partnerships. This document also contains temporary regulations under section 987 providing: an annual deemed termination election for a section 987 QBU; an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; rules regarding the treatment of section 988 transactions of a section 987 QBU; rules regarding QBUs with the U.S. dollar as their functional currency; rules regarding combinations and separations of section 987 QBUs; rules regarding the translation of income used to pay creditable foreign income taxes; and rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987. Finally, this document contains temporary regulations under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Bulletin.** In addition, in the Rules and Regulations section of this issue of the **Bulletin**, final regulations are being issued under section 987 to provide general guidance under section 987 regarding the determination of the taxable income or loss of a taxpayer with respect to a QBU.

DATES: *Effective date*. These regulations are effective on December 7, 2016.
Applicability date. For dates of applicability, see §§ 1.987–1T(h), 1.987–2T(e), 1.987–3T(f), 1.987–4T(h), 1.987–6T(d), 1.987–7T(d), 1.987–8T(g), 1.987–12T(j), 1.988–1T(j), and 1.988–2T(j).

FOR FURTHER INFORMATION CONTACT:Steven D. Jensen at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-2265. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, the accuracy of the estimated burden and suggestions for reducing this burden, and where to submit comments on the collection of information, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Bulletin.**

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains temporary regulations under section 987 of the Code relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a QBU in connection with certain QBU terminations and certain other transactions involving partnerships. This document also contains temporary regulations under section 987 providing (i) an annual deemed termination election for a section 987 QBU; (ii) an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; (iii) rules regarding the treatment of section 988 transactions of a section 987 QBU; (iv) rules regarding QBUs with the U.S. dollar as their functional currency; (v) rules regarding combinations and separations of section 987 QBUs; (vi) rules regarding the translation of income used to pay creditable foreign income taxes; and (vii) rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987. Finally, this document contains temporary regulations under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans.

Section 987 generally provides that, when a taxpayer owns one or more QBUs with a functional currency other than the U.S. dollar and such functional currency is different than that of the taxpayer, the taxable income or loss of the taxpayer with respect to each such QBU is determined by computing the taxable income or loss of each QBU separately in its functional currency and translating such income or loss at the appropriate exchange rate. Section 987 further requires the taxpayer to make "proper adjustments" (as prescribed by the Secretary of the Treasury (the Secretary)) for transfers of property between QBUs having different functional currencies, including by treating post-1986 remittances from each such QBU as made on a pro rata basis out of post-1986 accumulated earnings, by treating section 987 gain or loss as ordinary income or loss, and by sourcing such gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.

Section 989(c) directs the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of [subpart J], including regulations . . . limiting the recognition of foreign currency loss on certain remittances from qualified business units . . . [and] providing for the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer) . . . ."

On September 6, 2006, the Treasury Department and the IRS issued proposed regulations under section 987 (REG–208270–86, 71 FR 52876) (the 2006 proposed regulations). The Treasury Department and the IRS received many written comments in response to the 2006 proposed regulations and, after consideration of those comments, are issuing final regulations (**TD 9794**) under section 987 (the final regulations) that are being published contemporaneously with these temporary regulations. These temporary regulations also reflect the consideration of comments received on the 2006 proposed regulations, as well as other considerations described in this preamble.

Explanation of Provisions

1. *Deferral of Section 987 Gain or Loss on Certain Terminations and Other Transactions Involving Partnerships*

A. *Background*

Under the final regulations, the owner of a section 987 QBU that terminates includes in income all of the net unrecognized section 987 gain or loss with respect to the section 987 QBU in the year it terminates. See §§ 1.987–5(c)(3) and 1.987–8(e). Section 1.987–8(b) and (c) describe the circumstances in which a section 987 QBU terminates, which include the transfer (or deemed transfer) of substantially all of the assets of the section 987 QBU and when the section 987 QBU's owner ceases to exist (except in connection with certain liquidations or reorganizations described in section 381(a)). Under these rules, a termination can result solely from a transfer of a section 987 QBU between related parties or, when a QBU is owned by an entity that is disregarded as an entity separate from its owner for Federal tax purposes (DE), from the deemed transfer that occurs when an election is made to treat the DE as a corporation for Federal tax purposes, notwithstanding that the QBU's assets continue to be used in the same trade or business.

The preamble to the 2006 proposed regulations requested comments regarding whether inbound liquidations under section 332 and inbound asset reorganizations under section 368(a) should result in terminations of section 987 QBUs. The preamble also requested comments on the interaction of the rules of § 1.1502–13 regarding intercompany transactions with the 2006 proposed regulations, including whether section 987 gain or loss resulting from the transfer of assets and liabilities of a section 987 QBU between members of the same consolidated group in a section 351 transaction should be deferred under § 1.1502–13. Many comments recommended that such a section 351 exchange should not trigger the recognition of section 987 gain or loss.

Because a termination can result in the deemed remittance of all the assets of a section 987 QBU in circumstances in which the assets continue to be used by a related person in the conduct of the same trade or business that formerly was conducted by the section 987 QBU, terminations can facilitate the selective recognition of section 987 losses. Section 989(c)(2) provides the Treasury Department and the IRS with authority to "limit[] the recognition of foreign currency loss on certain remittances from qualified business units." The Treasury Department and the IRS have determined that terminations of section 987 QBUs generally should not be permitted to achieve the selective recognition of losses when the assets and liabilities of the section 987 QBU are transferred to a related person and remain subject to section 987 in the hands of the transferee, as in the case, for example, of a section 351 transfer of a section 987 QBU within a consolidated group. Similar policy considerations arise when the transfer of a partnership interest to a related person results in deemed transfers that cause the recognition of section 987 loss with respect to a section 987 QBU owned through the partnership, notwithstanding that the trade or business of the section 987 QBU continues without interruption and remains subject to section 987. In order to address these policy concerns, as described in greater detail in Part 1.C of this Explanation of Provisions, the temporary regulations defer section 987 losses resulting from certain termination events and partnership transactions in which the assets and liabilities of the section 987 QBU remain within a single controlled group (defined as all persons with the relationships to each other described in sections 267(b) or 707(b)) and remain subject to section 987.

The Treasury Department and the IRS also acknowledge, however, that part of the rationale for deferring section 987 losses — that is, the continuity of ownership of the section 987 QBU within a single controlled group — applies equally to section 987 gains that otherwise would be triggered when taxpayers transfer a section 987 QBU within a single controlled group. Thus, consistent with the recommendations of comments on the 2006 proposed regulations, the temporary regulations generally apply to defer the recognition of section 987 gains as well as losses when the transferee is subject to section 987 with respect to the assets of the section 987 QBU. The Treasury Department and the IRS have determined, however, that gain should not be deferred to the extent the assets of a section 987 QBU are transferred by a U.S. person to a related foreign person. Since recognition of the deferred gain generally would occur only as a result of remittances to the foreign owner, the IRS could face administrative difficulty in attempting to ensure that such deferred gain is appropriately recognized and not indefinitely deferred. Treating gains differently than losses in the context of transfers to related foreign persons generally is consistent with the policies underlying sections 267 and 367. In particular, this rule is consistent with the policy of recognizing foreign currency gains and not losses with respect to property transferred outbound in a nonrecognition transaction. See section 367(a)(3)(B)(iii).

In addition, the Treasury Department and the IRS have determined that selective recognition of losses should not be permitted in the context of certain outbound transfers even when the assets do not remain subject to section 987 in the hands of the transferee (because, for example, the transferee has the same functional currency as the QBU). Accordingly, consistent with the principles of sections 267 and 367(a), the temporary regulations also provide special rules to prevent the selective recognition of section 987 losses in certain other transactions involving outbound transfers.

B. *Scope of application of § 1.987–12T*

Section 1.987–12T provides for the deferral of certain net unrecognized section 987 gain or loss that otherwise would be recognized in connection with specified events under § 1.987–5, which governs the recognition of section 987 gain or loss by the owner of a section 987 QBU to which the final regulations apply. In addition, because the policy concerns that motivate § 1.987–12T exist regardless of whether section 987 gain or loss is computed pursuant to the final regulations or some other reasonable method, § 1.987–12T applies to any foreign currency gain or loss realized under section 987(3), including foreign currency gain or loss realized under section 987 with respect to a QBU to which the final regulations generally are not applicable. In order to achieve this, the temporary regulations specify that references in § 1.987–12T to section 987 gain or loss refer to any foreign currency gain or loss realized under section 987(3) and that references to a section 987 QBU refer to any eligible QBU (as defined in § 1.987–1(b)(3)(i), but without regard to § 1.987–1(b)(3)(ii)) that is subject to section 987. Additionally, the temporary regulations specify that references in § 1.987–12T to the recognition of section 987 gain or loss under § 1.987–5 encompass any determination and recognition of gain or loss under section 987(3) that would occur but for § 1.987–12T. Accordingly, the temporary regulations require an owner of a QBU that is not subject to § 1.987–5 to adapt the rules set forth in § 1.987–12T to recognize section 987 gains or losses consistent with the principles of § 1.987–12T.

The policy concerns regarding selective realization of section 987 losses do not apply, however, with respect to a section 987 QBU that has made the annual deemed termination election described in Part 2 of this Explanation of Provisions, because all section 987 gain and loss is recognized annually under that election. Accordingly, § 1.987–12T is not applicable to section 987 gain or loss of a section 987 QBU with respect to which the annual deemed termination election is in effect.

Finally, in order to avoid any compliance burden associated with applying § 1.987–12T in circumstances involving relatively small amounts of section 987 gain or loss, § 1.987–12T includes a de minimis rule. That rule provides that § 1.987–12T does not apply to a section 987 QBU if the net unrecognized section 987 gain or loss of the section 987 QBU that, as a result of § 1.987–12T, would not be recognized under § 1.987–5 does not exceed $5 million.

Section 1.987–12T defers the recognition of section 987 gains and losses in connection with two types of specified events, which are referred to as "deferral events" and "outbound loss events." Parts 1.C and 1.D of this Explanation of Provisions describe the rules governing deferral events and outbound loss events, respectively.

C. *Deferral events*

As described in greater detail below, the temporary regulations provide that, notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which a deferral event occurs (a deferral QBU) must defer section 987 gain or loss that otherwise would be taken into account under § 1.987–5 in connection with the deferral event to the extent determined under § 1.987–12T(b)(3) and (c). Such deferred gain or loss is taken into account based on subsequent events in accordance with § 1.987–12T(c).

i. Deferral Events

The temporary regulations provide that a deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy two conditions. Under the first condition, the transaction or series of transactions must be described in one of two categories. The first category, which is set forth in § 1.987–12T(b)(2)(ii)(A), is any termination of a section 987 QBU other than (i) a termination described in § 1.987–8(b)(3) (that is, a termination that results from the owner of the section 987 QBU ceasing to be a controlled foreign corporation (as defined in section 957(a)) (CFC) after certain related-party transactions); (ii) a termination described in § 1.987–8(c) (that is, a termination that results from a liquidation or asset reorganization described in section 381(a) involving an inbound or outbound transfer, a transfer by a CFC to a related non-CFC foreign corporation, or a transfer to a transferee that has the same functional currency as the section 987 QBU);[11] or (iii) a termination described solely in § 1.987–8(b)(1) (that is, a termination that results solely from the cessation of the trade or business of the section 987 QBU). Thus, the first category generally involves terminations that occur as a result of a transfer of substantially all the assets of a section 987 QBU other than a transfer as part of a transaction described in section 381(a) in which the owner ceases to exist. (A termination that results from an outbound section 381(a) transaction, however, may be an outbound loss event.)

The second category, which is described in § 1.987–12T(b)(ii)(B), encompasses certain partnership transactions that result in a net deemed transfer from a section 987 QBU to its owner as a result of which section 987 gain or loss otherwise would be recognized under § 1.987–5. The second category refers to two types of transactions involving partnerships.

[11]The transfer of a section 987 QBU as part of a liquidation or asset reorganization described in section 381(a) in which the transferor and transferee have the same tax status is not a termination under § 1.987–8(b) and (c) and, therefore, cannot constitute a deferral event under the first category.

First, the second category includes a disposition of part of an interest in a DE or partnership. Under § 1.987–2(c)(5), a transfer of part of an interest in a DE or section 987 aggregate partnership results in deemed transfers to the owner of a section 987 QBU held through that DE or partnership that may result in a remittance, but that generally do not cause a termination. For an illustration of the application of § 1.987–12T to a deferral event resulting from the conversion of a disregarded entity into a section 987 aggregate partnership, see § 1.987–12T(h), *Example 4*.

The second type of transaction included in the second category is a contribution of assets by a related person to a partnership or DE through which a section 987 QBU is held, provided that the contributed assets are not included on the books and records of an eligible QBU and the contribution causes a net transfer from a section 987 QBU owned through the partnership or DE. The rules of § 1.987–2 must be applied to determine whether the contribution would cause a net transfer from any section 987 QBUs held through a partnership. For example, if two partners (Partner A and Partner B) each own a 50% interest in an existing section 987 aggregate partnership with a single section 987 QBU, and Partner A contributes cash that is included on the books of the section 987 QBU after the contribution and Partner B contributes an equal amount of non-portfolio stock, the contributions would not cause either Partner A nor Partner B to have a net transfer from the section 987 QBU under § 1.987–2 and there would be no section 987 gain or loss to defer. As a result of the broad scope of application for § 1.987–12T specified in § 1.987–12T(a)(2), the second category includes transactions involving partnerships that are not section 987 aggregate partnerships even though QBUs that are held through such partnerships generally are not subject to the final regulations. Accordingly, § 1.987–12T applies to a disposition of a partnership interest or a contribution to a partnership if it otherwise would result in recognition of gain or loss under a taxpayer's reasonable method of applying section 987.

The second condition described in § 1.987–12T(b)(2) is that, immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor QBU. For this purpose, a successor QBU with respect to a section 987 QBU (original QBU) generally means a section 987 QBU on whose books and records assets of the original QBU are reflected immediately after the deferral event, provided that, immediately after the deferral event, the section 987 QBU is owned by a member of the controlled group that includes the person that owned the original QBU immediately before the deferral event. This relatedness requirement would not be met, for example, if the person that owned the original QBU ceased to exist in connection with the deferral event.

However, if the owner of the original QBU is a U.S. person, then a successor QBU does not include a section 987 QBU owned by a foreign person, except in the case of a deferral event that is solely described in the second category of transactions involving partnership and DE interests. This limitation on the definition of a successor QBU in the context of outbound transfers serves two purposes. First, consistent with the general policy of recognizing foreign currency gains upon an outbound transfer, the limitation ensures that section 987 gain is recognized to the extent section 987 QBU assets are transferred outbound in connection with a termination. Second, the limitation coordinates the deferral event rules with the outbound loss event rules described in Part 1.D of this Explanation of Provisions, which contain different rules for the recognition of section 987 loss attributable to assets of a section 987 QBU that are transferred outbound in connection with a termination of the section 987 QBU.

ii. Recognition of Section 987 Gain or Loss Under § 1.987–5 in the Taxable Year of a Deferral Event

The temporary regulations provide that, in the taxable year of a deferral event, the owner of the deferral QBU generally recognizes section 987 gain or loss as determined under § 1.987–5, except that, solely for purposes of applying § 1.987–5, all assets and liabilities of the deferral QBU that, immediately after the deferral event, are properly reflected on the balance sheet of a successor QBU are treated as not having been transferred and therefore as remaining on the balance sheet of the deferral QBU, notwithstanding the deferral event. The effect of these rules is that, in the taxable year of a deferral event, only assets and liabilities of the deferral QBU that are not reflected on the books and records of a successor QBU immediately after the deferral event are taken into account in determining the amount of a remittance from the deferral QBU. Section 987 gain or loss that, as a result of these rules, is not recognized under § 1.987–5 in the taxable year of the deferral event is referred to as deferred section 987 gain or loss. As discussed in Part 1.D of this Explanation of Provisions, if the deferral event also constitutes an outbound loss event, the amount of loss recognized by the owner may be further limited under the rules applicable to outbound loss events.

iii. Recognition of Deferred Section 987 Gain or Loss in the Taxable Year of a Deferral Event and in Subsequent Taxable Years

The temporary regulations provide rules for determining when a deferral QBU owner recognizes deferred section 987 gain or loss. For this purpose, a deferral QBU owner means, with respect to a deferral QBU, the owner of the deferral QBU immediately before the deferral event with respect to the deferral QBU or the owner's qualified successor. The temporary regulations define a qualified successor with respect to a corporation (transferor corporation) as another corporation (acquiring corporation) that acquires the assets of the transferor corporation in a transaction described in section 381(a), but only if (A) the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or (B) the acquiring corporation is a CFC and the transferor corporation was a CFC. A qualified successor of a corporation includes a qualified successor of a qualified successor of the corporation.

As described in the remainder of this Part 1.C.iii, the temporary regulations provide that deferred section 987 gain or loss is recognized upon subsequent remittances from a successor QBU, or upon a deemed remittance that occurs when a successor QBU ceases to be owned by a member of the deferral QBU owner's controlled group, subject to an exception that applies when a successor QBU terminates in an outbound transfer. In general, these rules depend on the continued existence of a deferral QBU owner (which includes a qualified successor) and a successor QBU and preserve the location of the deferred section 987 gain or loss as gain or loss of the deferral QBU owner.

a. Subsequent remittances

A deferral QBU owner generally recognizes deferred section 987 gain or loss in the taxable year of a remittance from a successor QBU to the owner of the successor QBU (successor QBU owner). The amount of deferred section 987 gain or loss that a deferral QBU owner recognizes upon a remittance is the outstanding deferred section 987 gain or loss (that is, the deferred section 987 gain or loss not previously recognized) multiplied by the remittance proportion of the successor QBU owner with respect to the successor QBU for the taxable year as determined under § 1.987–5(b) and, to the extent relevant, § 1.987–12T. For an illustration of this rule, see § 1.987–12T(h), *Example 5*.

In certain cases, there may be multiple successor QBUs with respect to a single deferral QBU. For instance, there may be multiple successor QBUs if the owner of a section 987 aggregate partnership interest transfers part of its interest or if a successor QBU separates into two or more separated QBUs under § 1.987–2T(c)(9)(ii). To ensure that a deferral QBU owner recognizes the appropriate amount of deferred section 987 gain or loss in connection with a remittance in such cases, the temporary regulations provide that multiple successor QBUs of the same deferral QBU are treated as a single successor QBU for purposes of determining the amount of deferred section 987 gain or loss that is recognized.

For example, if the owner (Corp A) of a section 987 aggregate partnership interest transfers part of its interest to another member of Corp A's consolidated group (Corp B), the transfer would give rise to a deferral event with respect to the section 987 QBU (QBU A) that Corp A indirectly owns through the partnership. QBU A would be considered a deferral QBU, and Corp A would be considered a deferral QBU owner. In addition, QBU A would be considered a successor QBU with respect to itself, and the section 987 QBU (QBU B) that Corp B owns indirectly through the partnership interest it acquired also would be considered a successor QBU with respect to QBU A. In determining the amount of deferred section 987 gain or loss recognized upon subsequent remittances from successor QBUs, the two successor QBUs are treated as a single successor QBU, such that their remittance proportion is determined under § 1.987–5 on a combined basis, taking into account the assets and remittances of both successor QBUs.

b. Deemed remittance when a successor QBU ceases to be owned by a member of the deferral QBU owner's controlled group

Solely for purposes of determining a deferral QBU owner's recognition of any outstanding deferred section 987 gain or loss, a successor QBU owner is treated as having a remittance proportion of 1 in a taxable year in which its successor QBU ceases to be owned by a member of a controlled group that includes the deferral QBU owner, including as a result of the deferral QBU owner ceasing to exist without having a qualified successor. Accordingly, a deferral QBU owner would recognize all outstanding deferred section 987 gain or loss upon a successor QBU ceasing to be owned by a member of the deferral QBU owner's controlled group if there is only one successor QBU, but would recognize only a proportional amount if there are multiple successor QBUs, one or more of which remain in the deferral QBU owner's controlled group.

c. Recognition of deferred section 987 loss in certain outbound successor QBU terminations

Notwithstanding that deferred section 987 gain or loss generally is recognized upon remittances from a successor QBU, § 1.987–12T(c)(3) provides that, if assets of a successor QBU are transferred (or deemed transferred) in an exchange that would constitute an outbound loss event if the successor QBU had a net accumulated section 987 loss at the time of the exchange, the deferral QBU owner recognizes any outstanding deferred section 987 loss on a similar basis as it would if it originally had transferred the deferral QBU in an outbound loss event. Any outstanding deferred section 987 loss with respect to the deferral QBU that, as a result of this rule, is not recognized is recognized by the deferral QBU owner in the first taxable year in which the deferral QBU owner (including any qualified successor) and the acquirer of the assets of the successor QBU (or any qualified successor) cease to be members of the same controlled group. Section 1.987–12T(c)(4) ensures that the policy concerns that motivate the treatment of outbound loss events under the temporary regulations apply in comparable circumstances involving successor QBUs. See Part 1.D of this Explanation of Provisions for an explanation of outbound loss events.

d. Special rules regarding successor QBUs

The temporary regulations include three special rules regarding successor QBUs that are relevant to the recognition of deferred section 987 gain or loss. First, if a section 987 QBU is a successor QBU with respect to a deferral QBU that is a successor QBU with respect to another deferral QBU, the first-mentioned section 987 QBU is considered a successor QBU with respect to the second-mentioned deferral QBU. For example, if QBU A is a successor QBU with respect to QBU B, and QBU B is a successor QBU with respect to QBU C, then QBU A is a successor QBU with respect to QBU C.

Second, if a successor QBU with respect to a deferral QBU separates into two or more separated QBUs (as defined in § 1.987–2T(c)(9)(iii)), each separated QBU is considered a successor QBU with respect to the deferral QBU.

Third, if a successor QBU with respect to a deferral QBU combines with another section 987 QBU of the same owner, resulting in a combined QBU (as defined in § 1.987–2T(c)(9)(i)), the combined QBU is considered a successor QBU with respect to the deferral QBU.

iv. Source and Character of Deferred Section 987 Gain and Loss

The temporary regulations provide that the source and character of deferred section 987 gain or loss is determined under § 1.987–6 as if such gain or loss had been recognized with respect to the deferral QBU under § 1.987–5 on the date of the deferral event that gave rise to the deferred section 987 gain or loss. Thus, the source and character of deferred section 987 gain or loss is determined under § 1.987–6 without regard to the timing rules of § 1.987–12T.

D. *Outbound loss events*

Section 1.987–12T(d) of the temporary regulations contains rules that defer section 987 loss to the extent assets of a section 987 QBU are transferred outbound to a related foreign person in connection with an "outbound loss event." Specifically, the temporary regulations provide that, notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which an outbound loss event occurs (outbound loss QBU) includes in taxable income in the year of the outbound loss event section 987 loss with respect to that section 987 QBU only to the extent provided in § 1.987–12T(d)(3). Sections 1.987–12T(d)(4) and (5) provide rules for the subsequent recognition of losses that are deferred under § 1.987–12T(d) that differ from the remittance-based rules that generally apply following deferral events.

Like the definition of deferral event, an outbound loss event includes two categories of transactions with respect to a section 987 QBU with net unrecognized section 987 loss. First, an outbound loss event includes any termination of the section 987 QBU in connection with a transfer of assets of the section 987 QBU by a U.S. person to a foreign person that was a member of the same controlled group as the U.S. transferor immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (related foreign person). The second category of outbound loss events includes any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership or DE through which the U.S. person owns the section 987 QBU to a related foreign person that has the same functional currency as the section 987 QBU. The second category also includes a contribution of assets by such a related foreign person to the partnership or DE if the contribution has the effect of reducing the U.S. person's interest in the section 987 QBU (and therefore causes a deemed transfer of assets and liabilities to the U.S. person from the section 987 QBU) and the contributed assets are not included on the books and records of an eligible QBU of the partnership or DE. The second category would be implicated, for example, if a U.S. person transferred part of the interest in a DE through which it owned a section 987 QBU to a foreign corporation that had the same functional currency as the section 987 QBU in an outbound section 351 transaction.

Under these rules, the owner of the outbound loss QBU recognizes section 987 loss in the taxable year of the outbound loss event as determined under § 1.987–5 and the deferral event rules of § 1.987–12T(b) and (c), except that, solely for purposes of applying § 1.987–5, certain assets and liabilities of the outbound loss QBU are treated as not having been transferred and therefore as remaining on the balance sheet of the section 987 QBU, notwithstanding the outbound loss event. In the first category of outbound loss event (involving outbound asset transfers resulting in terminations), assets and liabilities that, immediately after the outbound loss event, are properly reflected on the books and records of the related foreign person or a section 987 QBU of the related foreign person are treated as not having been transferred. In the second category of outbound loss event (involving certain partnership and DE transactions), assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the eligible QBU from which the assets and liabilities of the outbound loss QBU are allocated, and not on the books and records of a section 987 QBU, are treated as not having been transferred. The difference between the amount that otherwise would have been recognized and the amount actually recognized under this rule is referred to as outbound section 987 loss.

Although an outbound loss event in the second category also would constitute a deferral event, the rules governing deferral events only defer section 987 loss of a deferral QBU to the extent assets and liabilities are reflected on the books and records of a successor QBU immediately after the deferral event. Assets and liabilities of a deferral QBU that are reflected on the books and records of an eligible QBU of a partnership and allocated to a partner that has the same functional currency as the eligible QBU, as would occur in an outbound loss event, are not reflected on the books and records of a successor QBU and so would not cause section 987 loss to be deferred under the deferral event rules. Thus, there is no overlap in terms of the effect of the outbound loss event rules and the deferral event rules.

If an outbound loss event results from the transfer of assets of the outbound loss QBU in a nonrecognition transaction, the basis of the stock that is received in the transaction is increased by an amount equal to the outbound section 987 loss. In effect, this rule converts a section 987 loss into an unrealized stock loss, which may be recognized upon a recognition event with respect to the stock. This treatment is similar to the treatment under section 367(a) of foreign currency losses with respect to foreign-currency denominated property that is transferred outbound in a nonrecognition event to a foreign corporation that has as its functional currency the currency in which the property is denominated. Outbound section 987 loss attributable to an outbound loss event that does not occur in connection with a nonrecognition transaction is recognized by the owner of the outbound loss QBU in the first taxable year in which the owner (or any qualified successor) and the related foreign person that participated in the outbound loss event (or any qualified successor) cease to be members of the same controlled group. In many circumstances this treatment will provide similar results as converting section 987 loss into stock basis as in the case of outbound loss events that result from a nonrecognition transaction.

The temporary regulations provide that, if loss is recognized on the sale or exchange of stock within two years of an outbound loss event that gave rise to an adjustment to the basis of the stock, then, to the extent of the outbound section 987 loss, the source and character of the loss recognized on the sale or exchange will be determined under § 1.987–6 as if such loss were section 987 loss recognized pursuant to § 1.987–5 without regard to § 1.987–12T on the date of the outbound loss event.

E. *Anti-abuse rule*

The temporary regulations provide an anti-abuse rule to address transactions structured to avoid the deferral rules in § 1.987–12T. This rule provides that no section 987 loss is recognized under § 1.987–5 in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of § 1.987–12T. This rule would apply, for example, if, with a principal purpose of recognizing a deferred section 987 loss, a taxpayer engaged in a transaction that caused a deferral QBU owner to cease to exist without a qualified successor or caused a successor QBU to cease to exist, such that deferred section 987 loss otherwise would be recognized under § 1.987–12T(c).

F. *Coordination with fresh start transition method*

The temporary regulations require adjustments to coordinate the application of § 1.987–12T with the fresh start transition method described in § 1.987–10(b) for transitioning to the final regulations. If a deferral QBU owner is required under § 1.987–10(a) to apply the fresh start transition method with respect to the deferral QBU on the transition date, or if a deferral QBU owner would have been so required if it had owned the deferral QBU on the transition date, the outstanding deferred section 987 gain or loss of the deferral QBU owner with respect to the deferral QBU must be adjusted on the transition date to equal the amount of outstanding deferred section 987 gain or loss that the deferral QBU owner would have had with respect to the deferral QBU on the transition date if, immediately before the deferral event, the deferral QBU had transitioned to the final regulations pursuant to the fresh start transition method. Additionally, if the owner of an outbound loss QBU is required under § 1.987–10(a) to apply the fresh start transition method with respect to the outbound loss QBU on the transition date, or if the owner would have been so required if it had owned the outbound loss QBU on the transition date, the basis of any stock that was subject to a basis adjustment under § 1.987–12T as a result of the outbound loss event must be adjusted to equal the basis that such stock would have had on the transition date if, immediately prior to the outbound loss event, the outbound loss QBU had transitioned to the final regulations pursuant to the fresh start transition method. Outbound section 987 loss that is not reflected in stock basis but that will be recognized when the owner and the related foreign person that participated in the outbound loss event cease to be members of the same controlled group must be adjusted in a similar manner. These adjustments to coordinate the application of § 1.987–12T with the fresh start transition method must be made even if the deferral QBU owner or the owner of the outbound loss QBU continues to own the deferral QBU or the outbound loss QBU on the transition date, as in the case of a deferral event or outbound loss event resulting from a transfer of part of an interest in a section 987 aggregate partnership that does not result in the termination of the deferral QBU or outbound loss QBU.

G. *Effective date*

The temporary regulations under § 1.987–12T generally apply to any deferral event or outbound loss event that occurs on or after *January 6, 2017*. However, if the deferral event or outbound loss event is undertaken with a principal purpose of recognizing section 987 loss, the 30 day delayed effective date does not apply and § 1.987–12T is effective immediately on December 7, 2016.

2. *Annual Deemed Termination Election*

A comment on the 2006 proposed regulations recommended that taxpayers be permitted to make a one-time election under § 1.987–5 to deem a section 987 QBU as having terminated at the end of each year, thereby requiring the owner to recognize all section 987 gains or losses with respect to the QBU on an annual basis. The comment suggested that such an election would allow taxpayers to reduce the complexity and administrative cost of complying with section 987 because taxpayers would not be required to track transactions between an owner and its section 987 QBU or unrecognized section 987 gains and losses carried over from previous years.

The Treasury Department and the IRS have determined that an annual deemed termination election would not obviate the need to track transactions between an owner and its section 987 QBU, since the net transfer would remain relevant to the annual calculation of section 987 gain or loss. Nonetheless, the Treasury Department and the IRS agree that an annual deemed termination election could enhance administrability of the final regulations by reducing the recordkeeping requirements necessary to apply the final regulations. Additionally, when an annual deemed termination election is in effect, taxpayers could not strategically time remittances in order to selectively recognize section 987 losses but not section 987 gains. Eliminating this planning opportunity would obviate the need for the deferral provisions of § 1.987–12T. Furthermore, as discussed in Part 3 of this Explanation of Provisions, an annual deemed termination election would address a policy concern with permitting the hybrid approach to section 987 suggested by comments on the 2006 proposed regulations.

Based on the foregoing considerations, § 1.987–8T(d) provides an election for a taxpayer to deem its section 987 QBUs to terminate on the last day of each taxable year for which the election is in effect. Because the considerations supporting an annual deemed termination election generally are relevant regardless of whether a taxpayer is subject to the final regulations, the election under § 1.987–8T(d) is available to any taxpayer without regard to the applicability of the final regulations to that taxpayer or any of its section 987 QBUs. A section 987 QBU to which this election applies is treated as having made a remittance of all of its gross assets to its owner immediately before the section 987 QBU terminates on the last day of each taxable year, resulting in the recognition of any net unrecognized section 987 gain or loss of the section 987 QBU. See §§ 1.987–5(c)(3) and 1.987–8(e). The owner is then treated as having transferred all of the assets and liabilities of the terminated section 987 QBU to a new section 987 QBU on the first day of the following taxable year.

As noted in Part 1 of this Explanation of Provisions, the temporary regulations provide that the deferral provisions of § 1.987–12T do not apply with respect to section 987 QBUs for which the annual deemed termination election is in effect. Consequently, a taxpayer that finds the annual deemed termination election preferable to § 1.987–12T based on ease of compliance or other reasons may make the annual deemed termination election. Moreover, as discussed in Part 3 of this Explanation of Provisions, a taxpayer that makes the annual deemed termination election with respect to a section 987 QBU may reduce the compliance burden associated with computing taxable income or loss under the final regulations by electing to translate taxable income or loss of the section 987 QBU into the owner's functional currency at the yearly average exchange rate without any adjustments.

The Treasury Department and the IRS have determined that special consistency and effective date rules are needed for the annual deemed termination election to prevent taxpayers from using the election to selectively recognize section 987 losses without recognizing section 987 gains. Unless the annual deemed termination election is required to be made with respect to all section QBUs owned by related persons at the time of the election, taxpayers could choose to make the election only with respect to section 987 QBUs that have net unrecognized section 987 losses at the time of the election. Accordingly, § 1.987–1T(g)(2)(i)(B)(*1*) provides that the annual deemed termination election generally applies to all section 987 QBUs owned by an electing taxpayer, as well as to all section 987 QBUs owned by any person that has a relationship to the taxpayer described in section 267(b) or section 707(b) (substituting "and the profits interest" for "or the profits interest" in section 707(b)(1)(A) and substituting "and profits interests" for "or profits interests" in section 707(b)(1)(B)) on the last day of the first taxable year for which the election applies to the taxpayer (a related person).

A taxpayer that is subject to the final regulations and that must transition to the final regulations under the fresh start transition method of § 1.987–10(b) (fresh start taxpayer) may make the annual deemed termination election only if the first taxable year for which the election would apply is either (i) the first taxable year beginning on or after the transition date (as defined in § 1.987–11(c)) with respect to the taxpayer or (ii) a subsequent taxable year in which the "taxpayer's controlled group aggregate section 987 loss" (if any) does not exceed $5 million. For this purpose, a "taxpayer's controlled group aggregate section 987 loss" means the aggregate net amount of section 987 gain or loss that would be recognized pursuant to the election under § 1.987–8T(d) by the taxpayer and all related persons in the first taxable year of each person for which the election would apply.

Taxpayers that used a method based on a reasonable application of the 2006 proposed regulations prior to the transition date, and which therefore are not subject to the fresh start transition method pursuant to § 1.987–10(c), and taxpayers for which the final regulations are not applicable, must follow the election rules for fresh start taxpayers if any related party is a fresh start taxpayer. If no related party is a fresh start taxpayer, the annual deemed termination election may be made only if the first taxable year for which the election would apply is either (i) the first taxable year beginning on or after December 7, 2016, in which the election is relevant in determining section 987 taxable income or loss or section 987 gain or loss or (ii) a subsequent taxable year in which the "taxpayer's controlled group aggregate section 987 loss" (if any) does not exceed $5 million.

If a taxpayer makes the annual deemed termination election, the election will apply to the first taxable year of a related person that ends with or within a taxable year of the taxpayer to which the taxpayer's election applies. Once made, the annual deemed termination election may not be revoked.

As provided in § 1.987–1T(g)(2)(i)(B)(*2*), the special consistency and effective date rules in § 1.987–1T(g)(2)(i)(B)(*1*) do not apply and a taxpayer may make a separate election under § 1.987–8T(d) with respect to any section 987 QBU owned by the taxpayer if the first taxable year for which the election would apply to the taxpayer with respect to the section 987 QBU is a taxable year in which the deemed termination results in the recognition of section 987 gain with respect to the section 987 QBU or the deemed termination results in the recognition of $1 million or less of section 987 loss with respect to the section 987 QBU.

3. *Election to Translate All Items at the Yearly Average Exchange Rate*

As discussed in the preamble to the final regulations, comments on the 2006 proposed regulations recommended a hybrid approach that would combine the methodology of the regulations proposed under section 987 in 1991 (INTL–965–86, 56 FR 48457) for computing a section 987 QBU's net income with the methodology of the 2006 proposed regulations for computing section 987 gain or loss. Under the proposed hybrid approach, section 987 gain or loss generally would be determined under the method of the 2006 proposed regulations, but taxable income or loss would be translated into the owner's functional currency at the yearly average exchange rate without any adjustments.

Although a hybrid approach would simplify the calculation of section 987 taxable income or loss, the preamble to the final regulations observes that the hybrid approach gives rise to offsetting effects in section 987 taxable income or loss and in the foreign exchange exposure pool (FEEP) that raise concerns similar to those addressed by Congress in enacting section 1092. In particular, under the hybrid approach, exchange rate effects with respect to historic assets would be reflected in section 987 taxable income or loss to the extent of any cost recovery deductions with respect to those assets, but equal and offsetting amounts would be reflected in the FEEP and would be recognized only upon remittances. Thus, offsetting effects arising from a single asset would be taken into account at different times. The Treasury Department and the

IRS have determined that it would be inappropriate for regulations under section 987 to permit distortions to section 987 taxable income or loss that have the effect of causing potentially large offsetting amounts of loss or gain to be reflected in the FEEP with respect to the same asset, since the loss or gain in the FEEP would be recognized only upon voluntary remittances from the QBU.

Nonetheless, the Treasury Department and the IRS acknowledge the concerns expressed in comments regarding the complexity of the 2006 proposed regulations that underlie the recommendation to adopt the hybrid approach. Concerns about offsetting amounts recognized at different times under the hybrid approach would not arise for taxpayers that make the annual deemed termination election set forth in § 1.987–8T(d). A taxpayer that recognizes all section 987 gain or loss with respect to its section 987 QBUs annually would take into account in recognized section 987 gain or loss the exchange rate effects with respect to historic assets that are reflected in the FEEP in the same taxable year in which the offsetting effects are taken into account in section 987 taxable income or loss. Although the hybrid approach could result in differences in character of exchange gain or loss relative to the final regulations even for taxpayers that make the annual deemed termination election, the Treasury Department and the IRS have determined that the administrative convenience of allowing taxpayers to translate a section 987 QBU's taxable income at the yearly average exchange rate outweighs that consideration.

Accordingly, the temporary regulations provide that a taxpayer that is otherwise generally subject to the final regulations may elect to apply the hybrid approach with respect to a section 987 QBU that is subject to the annual deemed termination election. In particular, § 1.987–3T(d) provides that, notwithstanding the rules of § 1.987–3(c) for translating items determined under § 1.987–3(b) in a section 987 QBU's functional currency into the owner's functional currency, a taxpayer may elect to translate all items of income, gain, deduction, and loss of a section 987 QBU with respect to which the annual deemed termination election described in § 1.987–8T(d) is in effect into the owner's functional currency, if necessary, at the yearly average exchange rate for the taxable year. An owner of multiple section 987 QBUs may make the election described in § 1.987–3T(d) with respect to all of its section 987 QBUs or only certain designated section 987 QBUs.

4. *Section 988 Transactions of a Section 987 QBU*

A. *Background regarding the treatment of section 988 transactions under the proposed regulations*

The 2006 proposed regulations reflected a two-pronged approach to the application of section 988 to transactions of a section 987 QBU, with different consequences generally depending on whether a transaction is denominated in (or determined by reference to) the owner's functional currency or a currency that is a nonfunctional currency with respect to both the owner and the section 987 QBU (third currency). As a general rule, § 1.987–3(e)(1) of the 2006 proposed regulations provided that section 988 applies to section 988 transactions attributable to a section 987 QBU and that the timing of any gain or loss is determined under the applicable provisions of the Code, but the 2006 proposed regulations did not clearly specify whether section 988 gain or loss would be determined with respect to the functional currency of the section 987 QBU or the owner's functional currency. Assets and liabilities giving rise to section 988 transactions were defined under proposed § 1.987–1(d) and (e) as historic items. Under § 1.987–3(e)(2) of the 2006 proposed regulations, transactions of a section 987 QBU described in section 988(c)(1)(B)(i) (relating to the acquisition of, or becoming an obligor under, a debt instrument), section 988(c)(1)(B)(ii) (relating to accrual of items of expense or gross income or receipts) or section 988(c)(1)(C) (relating to the disposition of nonfunctional currency) that are denominated in (or determined by reference to) the owner's functional currency, however, were not treated as section 988 transactions of the section 987 QBU, and no gain or loss was recognized under section 988 with respect to such transactions. Assets and liabilities giving rise to such transactions were required to be reflected on the balance sheet of the section 987 QBU in the owner's functional currency under § 1.987–2(d)(2) of the 2006 proposed regulations.

Additionally, § 1.987–3(d) of the 2006 proposed regulations provided that an item of income, gain, deduction, or loss of a section 987 QBU denominated in a currency other than the functional currency of the owner is translated at the spot rate on date the item is appropriately taken into account. Under § 1.987–3(c) of the 2006 proposed regulations, an item of income, gain, deduction, or loss of a section 987 QBU denominated in the owner's functional currency is not translated and is taken into account by the section 987 QBU in the owner's functional currency.

One comment indicated that the 2006 proposed regulations were unclear regarding the interaction of the rules for the treatment of section 988 transactions denominated in a third currency with the treatment of assets that give rise to section 988 transactions as historic assets. Upon the disposition of a historic asset, the 2006 proposed regulations required translation of the basis of the historic asset at the historic rate and the amount realized with respect to the asset at the yearly average exchange rate for the taxable year of the disposition or, if properly elected, the appropriate spot rate. Yet, § 1.987–3(f), *Example 10* of the 2006 proposed regulations illustrated the determination of section 988 gain or loss on a third-currency section 988 transaction in, and by reference to, the section 987 QBU's functional currency and translation of that amount into the owner's functional currency at the yearly average exchange rate. Under the approach of the example, historic asset basis is effectively translated at the yearly average exchange rate rather than the appropriate historic rate.

B. *General rules for section 988 transactions in the temporary regulations*

In light of the comment regarding the uncertain application of section 988 to transactions of a section 987 QBU under the 2006 proposed regulations and further consideration of the appropriate rules, the temporary regulations clarify and elaborate upon the application of section 988 to transactions attributable to a section 987 QBU. In this regard, the Treasury Department and the IRS have determined that computing section 988 gain or loss by reference to the functional currency of the section 987 QBU, rather than the owner's functional currency, and translating that amount at the yearly average exchange rate would be inconsistent with the treatment of items that give rise to section 988 transactions as historic items. Such items were treated as historic items under the 2006 proposed regulations because they do not economically expose the owner to fluctuations in the section 987 QBU's functional currency.

Taking these considerations into account, the Treasury Department and the IRS have determined that it is appropriate to continue to treat assets and liabilities giving rise to section 988 transactions of a section 987 QBU as historic items under §§ 1.987–1(d) and (e) of the final regulations. Thus, for example, a note denominated in a nonfunctional currency that gives rise to a section 988 transaction when acquired is a historic asset. However, the temporary regulations generally provide that section 988 gain or loss arising from section 988 transactions of a section 987 QBU is determined by reference to the owner's functional currency, rather than the functional currency of the section 987 QBU. See § 1.987–3T(b)(4)(i). Accordingly, in determining section 988 gain or loss with respect to a section 988 transaction of a section 987 QBU, the amounts required under section 988 to be translated on the applicable booking date or payment date with respect to the section 988 transaction are translated from the currency in which the amounts are denominated (or by reference to which they are determined) into the owner's functional currency at the rate required under section 988 and the section 988 regulations, which provide for translation at the appropriate spot rate.

When a section 987 QBU recognizes gain or loss on the disposition of a historic asset that gives rise to a section 988 transaction, some or all of the total gain or loss that is realized on the disposition may be section 988 gain or loss that, under section 988, is ordinary income that is sourced by reference to the residence of the section 987 QBU. For example, on the disposition of a nonfunctional currency note, the total gain or loss realized may be comprised of section 988 gain or loss that reflects exchange rate changes and other gain or loss that reflects other factors, such as changes in prevailing interest rates or in the creditworthiness of the note issuer. The total gain or loss on the disposition of a historic asset that gives rise to a section 988 transaction is determined under the general rules of section 987 by reference to the functional currency of the section 987 QBU. Section 988 gain or loss on the note is determined under §§ 1.988–2(b)(5) and (8) and 1.987–3T(b)(4)(i) by comparing the section 987 QBU's acquisition price for the note in nonfunctional currency translated into the owner's functional currency at the spot rates on the date of acquisition and the date of disposition, respectively. See § 1.987–3T(e), *Example 11*. To provide for consistent translation rates for determining both the total gain or loss on such a historic asset and the portion of the total gain or loss that is section 988 gain or loss, § 1.987–3T(c)(2)(ii) specifies that the spot rate also must be used to translate the amount received with respect to a historic asset if the acquisition of the historic asset gave rise to a section 988 transaction. Additionally, consistent with the regulations under § 1.988–1(d) regarding the use of spot rate conventions for section 988 transactions, § 1.987–1T(c)(1)(ii)(B) specifies that the election in § 1.987–1(c)(1)(ii)(A) to use a spot rate convention generally does not apply for purposes of determining section 987 taxable income or loss with respect to a historic item (as defined in § 1.987–1(e)) if acquiring, accruing, or entering into such item gave rise to a section 988 transaction or a specified owner functional currency transaction (discussed in this Part B).

Because assets and liabilities that give rise to section 988 transactions generally are historic items that have a spot rate as the historic rate under § 1.987–1T(c)(3)(i)(E), such assets and liabilities are translated at historic rates and do not give rise to section 987 gain or loss. Thus, when the general rules for section 988 transactions of a section 987 QBU apply, the owner will take into account under subpart J foreign currency exposure with respect to a section 988 transaction of a section 987 QBU only to the extent of the owner's economic exposure to fluctuations of its functional currency relative to the currency in which the section 988 transaction is denominated.

Additionally, consistent with the 2006 proposed regulations, the temporary regulations confirm that certain transactions that are denominated in (or determined by reference to) the owner's functional currency are not subject to section 988. Specifically, § 1.987–3T(b)(4)(ii) provides that specified owner functional currency transactions, which are defined as transactions described in section 988(c)(1)(B)(i) or (ii) or section 988(c)(1)(C) (including the acquisition of nonfunctional currency described in § 1.988–1(a)(1)) that are denominated in (or determined by reference to) the owner's functional currency, other than certain transactions described in § 1.987–3T(b)(4)(iii)(A) that are subject to a mark-to-market regime (discussed in Part 4.C of this Explanation of Provisions), are not treated as section 988 transactions. Although the temporary regulations do not follow the 2006 proposed regulations in specifying that assets and liabilities that give rise to specified owner functional currency transactions must be reflected on the balance sheet of the section 987 QBU in the owner's functional currency, the temporary regulations treat items that give rise to specified owner functional currency transactions as historic items that generally have a spot rate as the historic rate under § 1.987–1T(c)(3)(i)(E) and provide under § 1.987–3T(b)(2)(ii) that the basis and amount realized of a historic asset that gives rise to a specified owner functional currency transactions are not translated if denominated in the owner's functional currency. Together, these rules have the same effect as the treatment of specified owner functional currency transactions under the 2006 proposed regulations.

C. *Special rules to allow greater conformity with the financial accounting treatment for certain section 988 transactions*

As discussed in the preamble to the final regulations, under the financial accounting standard described in Accounting Standards Codification, Foreign Currency Matters, section 830 (ASC 830), gains and losses from changes in exchange rates with respect to transactions that are denominated in a currency other than the entity's functional currency are referred to as "transaction" gains and losses. The category of foreign currency transactions that give rise to transaction gains and losses for financial accounting purposes overlaps considerably with the definition of a section 988 transaction for tax purposes, such that transaction gains and losses under financial accounting rules are conceptually similar to section 988 gains and losses. The financial accounting rules require the inclusion of transaction gains and losses in net income for the period in which the exchange rate changes occur. See ASC 830-20-35-1. Moreover, transaction gain or loss is always determined by reference to the functional currency of the entity that entered into the transaction. Thus, the financial accounting rules differ from the general tax rules applicable to section 988 transactions entered into by a section 987 QBU in two respects. First, the financial accounting rules require transaction gain or loss to be determined on a mark-to-market basis, whereas gain or loss from a section 988 transaction generally is not recognized until there is a realization event under general tax principles and the applicable provisions of the Code. Second, the financial accounting rules require transaction gain or loss to be determined by reference to the entity's functional currency, even when it differs from the reporting currency used in the consolidated financial statements and the transaction is denominated in the reporting currency.

As noted in the preamble to the final regulations, comments on the 2006 proposed regulations expressed a preference for greater consistency of the section 987 regulations with financial accounting rules. Taking these comments into account, the Treasury Department and the IRS have determined that providing treatment similar to the financial accounting treatment for certain section 988 transactions of section 987 QBUs will enhance administrability of the section 987 regulations with respect to such transactions and is consistent with the policies of sections 987 and 988.

Accordingly, as discussed in Part 1.C.i of this Explanation of Provisions, the temporary regulations permit a taxpayer to elect to determine section 987 gain or loss with respect to qualified short-term section 988 transactions (described in Part 1.C.i of this Explanation of Provisions) of a section 987 QBU under a foreign currency mark-to-market method of accounting. In addition, as discussed in Part 4.C.ii of this Explanation of Provisions, the temporary regulations provide that section 988 gain or loss with respect to qualified short-term section 988 transactions that are accounted for under a mark-to-market method of accounting for Federal tax purposes (including the elective method described in Part 1.C.i of this Explanation of Provisions) is determined in, and by reference to, the functional currency of the section 987 QBU rather than the functional currency of its owner.

i. Election to Apply a Foreign Currency Mark-to-Market Method of Accounting for Certain Section 988 Transactions

The Treasury Department and the IRS have determined that allowing a taxpayer to mark to market foreign currency gain or loss with respect to qualified short-term section 988 transactions of a section 987 QBU will enhance administrability by aligning the timing for recognizing gain or loss with respect to such transactions with the financial accounting rules. Accordingly, a taxpayer may elect, on a QBU-by-QBU basis, under § 1.987–3T(b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting to qualified short-term section 988 transactions. Under this election, the timing of section 988 gain or loss is determined for applicable transactions under the principles of section 1256(a)(1). Thus, when the election applies, section 988 gain or loss with respect to a qualified short-term section 988 transaction is recognized on an annual basis, but other gain or loss with respect to any property underlying the transaction (e.g., gain or loss on a debt instrument due to interest rate fluctuations) is determined under the otherwise applicable recognition provisions.

A qualified short-term section 988 transaction is defined in § 1.987–3T(b)(4)(iii)(B) as a section 988 transaction, including a transaction denominated in the owner's functional currency, that both (1) occurs in the ordinary course of the section 987 QBU's business and (2) has an original term of one year or less on the day it is entered into by the section 987 QBU. The holding of currency that is nonfunctional currency (within the meaning of section 988(c)(1)(C)(ii)) to the section 987 QBU in the ordinary course of a section 987 QBU's trade or business also is treated as a qualified short-term section 988 transaction.

ii. Special Rule Requiring Gain or Loss from Certain Section 988 Transactions that are Subject to a Mark-to-Market Method of Accounting to be Determined by Reference to the Functional Currency of the Section 987 QBU

The temporary regulations include a special rule for determining section 988 gain or loss with respect to qualified short-term section 988 transactions (as described in Part 4.C.i of this Explanation of Provisions) of a section 987 QBU that are accounted for under a mark-to-market method of accounting. Specifically, § 1.987–3T(b)(4)(iii)(A) provides that section 988 gain or loss with respect to qualified short-term section 988 transactions of a section 987 QBU, and certain related hedges, that are accounted for under a mark-to-market method of accounting under section 475, section 1256, or § 1.987–3T(b)(4)(iii)(C) (discussed in Part 4.C.i of this Explanation of Provisions) is determined in, and by reference to, the functional currency of the section 987 QBU rather than the owner's functional currency. Items that give rise to qualified short-term section 988 transactions for which section 988 gain or loss is determined under § 1.987–3T(b)(4)(iii)(A) by reference to the section 987 QBU's functional currency are treated as marked items under § 1.987–1T(d)(3), with the result that gain or loss attributable to such items is translated at the yearly average exchange rate and that such items give rise to net unrecognized section 987 gain or loss.

Under the rules for qualified short-term section 988 transactions accounted for under a mark-to-market method of accounting, a section 987 QBU owner will take into account the full amount of its economic foreign currency exposure arising from such transactions, but the effects of such exposure generally will be bifurcated into a component reflected in section 987 taxable income or loss and a component reflected in the FEEP pool and recognized upon a remittance. These components could offset each other if the currency in which the section 988 transaction is denominated and the owner's functional currency moved in opposite directions relative to the section 987 QBU's functional currency. Restricting this treatment to qualified short-term section 988 transactions accounted for under a mark-to-market method of accounting limits the potential for abusive planning. In particular, the restriction to transactions accounted for under a mark-to-market method of accounting prevents selective realization of section 988 losses that would be taken into account in section 987 taxable income or loss in situations in which an offsetting gain is reflected in the FEEP. Additionally, short-term, ordinary-course section 988 transactions are less likely than other section 988 transactions to give rise to substantial offsetting effects in section 987 taxable income or loss and in the FEEP.

5. *Application of Section 987 to QBUs with the U.S. Dollar as a Functional Currency*

Consistent with the opening clause of section 987, which indicates that section 987 applies to the determination of the taxable income of any taxpayer "having 1 or more qualified business units with a functional currency other than the dollar," § 1.987–1T(b)(6)(i) sets forth a general rule that section 987 and the regulations thereunder do not apply with respect to an eligible QBU (determined without regard to the scope limitations of § 1.987–1(b)(3)(ii)) that has the U.S. dollar as its functional currency and that would be subject to section 987 if it had a functional currency other than the U.S. dollar (dollar QBU).

The Treasury Department and the IRS have determined, however, that it is appropriate for a CFC that is the owner of a dollar QBU to recognize foreign currency gain or loss with respect to transactions of the dollar QBU that would be section 988 transactions if entered into directly by the owner. Accordingly, pursuant to the authority granted in section 985(a), § 1.987–1T(b)(6)(ii)(A) provides that the CFC owner of a dollar QBU will be subject to section 988 with respect to any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU. For purposes of applying section 988 to such items, § 1.987–1T(b)(6)(ii)(A) provides that such items are treated as properly reflected on the books and records of the dollar QBU's owner. Thus, except as provided in the special rule described later in this Part 5 of this Explanation of Provisions for computing income that is effectively connected with the conduct of a trade or business within the United States (ECI), a CFC would determine section 988 gain or loss from transactions of a dollar QBU by reference to the CFC's functional currency. For example, for purposes of determining its earnings and profits, a CFC that has a euro functional currency and that is the owner of a dollar QBU with a U.S. dollar-denominated liability would apply section 988 with respect to that U.S. dollar-denominated liability, measuring section 988 gain or loss on the section 988 transaction arising from the liability by reference to the euro.

As a result of treating such items as properly reflected on the books and records of the CFC, instead of those of the dollar QBU, the CFC's section 988 gain or loss with respect to such items generally would be treated as foreign source income because section 988(a)(3) generally provides that the source of section 988 gain or loss is determined by reference to the residence of the taxpayer or QBU on whose books the asset, liability, or other item giving rise to the section 988 transaction is properly reflected. Section 1.988–4 then would apply to determine whether the section 988 gain or loss would be treated as ECI. Because a QBU with ECI must have the U.S. dollar as its functional currency (§ 1.985–1(b)(1)(v)), section 988 gain or loss measured by reference to the owner CFC's functional currency would not be ECI. However, the temporary regulations provide a special rule for certain section 988 transactions of a dollar QBU (including section 988 transactions denominated in the owner's functional currency) that arise from the conduct of a United States trade or business.

The special rule applies to a CFC owner of a dollar QBU that would have a section 988 transaction that would give rise to section 988 gain or loss that would be treated as ECI under § 1.988–4(c) if the item that would give rise to the section 988 transaction were treated as properly reflected on the books and records of the dollar QBU. Under § 1.987–1T(b)(6)(ii)(B), solely for purposes of determining the amount of section 988 gain or loss of the CFC that is ECI, any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU and, consequently, is determined by reference to the U.S. dollar.

The application of § 1.987–1T(b)(6)(ii) to a section 988 transaction that is denominated in a third currency (that is, neither the CFC's functional currency nor the U.S. dollar) could result in the same section 988 transaction generating ECI (determined by reference to the U.S. dollar) and generating subpart F income (determined by reference to the CFC owner's functional currency), subject to any limitation imposed by section 952(b). Under section 952(b), if the amount determined under § 1.987–1T(b)(6)(ii)(A) by reference to the owner's functional currency and the amount of ECI determined under § 1.987–1T(b)(6)(ii)(B) were both gains, only the excess, if any, of the gain determined by reference to the owner's functional currency over the ECI gain would be taken into account in determining subpart F income. If the amount determined under § 1.987–1T(b)(6)(ii)(A) by reference to the owner's functional currency and the amount of ECI determined under § 1.987–1T(b)(6)(ii)(B) were both losses, the loss determined by reference to the owner's functional currency would be taken into account in determining subpart F income only to the extent it exceeds the ECI loss.

The Treasury Department and the IRS recognize the potential administrative burden associated with applying the foregoing rules to a dollar QBU, which may give rise to a large number of section 988 transactions. Accordingly, § 1.987–1T(b)(6)(iii) provides an election for a CFC that directly or indirectly owns a dollar QBU to apply section 987 and the regulations thereunder in lieu of applying section 988 pursuant to § 1.987–1T(b)(6)(ii). The Treasury Department and the IRS have determined that, when this election applies, the source of foreign currency gain or loss that is determined under section 987 pursuant to the election should be consistent with the source that would have been determined under section 988 in the absence of the election. Accordingly, consistent with the source rule in section 988(a)(3), § 1.987–6T(b)(4) provides that the source of section 987 gain or loss determined with respect to a dollar QBU for which the owner has elected to apply section 987 is determined by reference to the residence of the CFC owner. Thus, such section 987 gain or loss will have a foreign source.

As is the case for dollar QBUs of CFCs that do not make the election under § 1.987–1T(b)(6)(iii) to apply section 987, CFCs that make the election and that have a dollar QBU that engages in a U.S. trade or business must apply a special rule to determine the amount of ECI that arises from transactions that would give rise to section 988 gain or loss if determined by reference to the dollar QBU's U.S. dollar functional currency. This special rule for determining the amount of ECI applies only to dollar QBUs that generate ECI because, under § 1.985–1(b)(1)(v), a QBU that produces income or loss that is, or is treated as, ECI must use the dollar as its functional currency. The special rule is needed for dollar QBUs that elect to be treated as section 987 QBUs because, under the general rules of § 1.987–3T(b)(4)(i) and (ii), which apply to all section 987 QBUs other than with respect to certain short-term transactions described in § 1.987–3T(b)(4)(iii)(B) that are accounted for under a mark-to-market method of accounting, section 988 gain or loss of a section 987 QBU with respect to transactions denominated in a third currency is determined in, and by reference to, the functional currency of the owner of the section 987 QBU, and section 988 gain or loss generally is not determined with respect to specified owner functional currency transactions described in Part 4.B of this Explanation of Provisions. Thus, in order to determine the appropriate amount of ECI from transactions of a dollar QBU for which an election to apply section 987 is in effect, § 1.987–1T(b)(6)(iii)(B) provides that, solely for purposes of determining the amount of section 988 gain or loss that is ECI, any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under § 1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating the item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar. For purposes of determining the amount of section 988 gain or loss for other purposes, including to determine the earnings and profits of the CFC, the rules in § 1.987–3T(b)(4)(i) and (ii) continue to apply. As is the case for a CFC that has not made the election to apply section 987 in lieu of section 988, a transaction to which the special rule applies could generate both ECI and subpart F income.

6. *Combinations and Separations of QBUs*

A. *Combinations and separations do not give rise to transfers*

Under § 1.987–2(c), an asset or liability is treated as transferred to a section 987 QBU from its owner if, as a result of a disregarded transaction, the asset or liability is reflected on the books and records of the section 987 QBU. Similarly, an asset or liability is treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, the asset or liability is no longer reflected on the books and records of the section 987 QBU. For this purpose, a disregarded transaction generally means a transaction that is not regarded for Federal income tax purposes. Absent a special rule, the combination of multiple section 987 QBUs that have the same owner, or the separation of a section 987 QBU into two or more section 987 QBUs that have the same owner, would give rise to a transfer between an owner and one or more section 987 QBUs under the final regulations.

Consistent with the policy of deferring section 987 gain or loss under § 1.987–12T when assets of a section 987 QBU are reflected on the books and records of another section 987 QBU in the same controlled group as a result of certain transactions that result in deemed transfers, the Treasury Department and the IRS have determined that it would not be appropriate for combinations or separations of section 987 QBUs of the same owner to give rise to transfers to or from the section 987 QBUs. Accordingly, under the temporary regulations, section 987 gain or loss generally is not recognized when two or more section 987 QBUs (combining QBUs) with the same owner combine into a single section 987 QBU (combined QBU) or when a section 987 QBU (separating QBU) separates into multiple section 987 QBUs (each, a separated QBU).

Specifically, notwithstanding the general rule of the final regulations, § 1.987–2T(c)(9)(i) provides that the combination of two or more combining QBUs that have the same owner into a combined QBU does not give rise to a transfer of any combining QBU's assets or liabilities to the owner. In addition, § 1.987–2T(c)(9)(i) provides that transactions between the combining QBUs occurring in the taxable year of the combination, which otherwise would give rise to transfers, do not result in a transfer of the combining QBUs' assets or liabilities to the owner under § 1.987–2(c). For this purpose, a combination occurs when the assets and liabilities that are properly reflected on the books and records of two or more combining QBUs begin to be properly reflected on the books and records of a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which combining QBUs become a combined QBU.

Similarly, § 1.987–2T(c)(9)(iii) provides that the separation of a separating QBU into two or more separated QBUs that have the same owner after the separation does not give rise to a transfer of any of the separating QBU's assets or liabilities to the owner. For this purpose, a separation occurs when assets and liabilities that are properly reflected on the books and records of a separating QBU begin to be properly reflected on the books and records of two or more separated QBUs. A separation may result from any transaction or series of transactions in which the separating QBU becomes two or more separated QBUs.

B. *Determination of net unrecognized section 987 gain or loss of combined QBUs and separated QBUs*

The temporary regulations generally require combining the aggregate net unrecognized section 987 gain or loss of combining QBUs for purposes of determining net unrecognized section 987 gain or loss of the combined QBU and require apportioning the net unrecognized section 987 gain or loss of a separating QBU among separated QBUs in proportion to their respective shares of the aggregate adjusted basis of the separating QBU's gross assets. Specifically, § 1.987–4T (f)(1) provides that the net unrecognized section 987 gain or loss of a combined QBU for a taxable year is determined by taking into account the net accumulated unrecognized section 987 gain or loss of each combining QBU for all prior taxable years for which the final regulations apply and treating the combining QBUs as having combined immediately prior to the beginning of the taxable year of combination. Additionally, § 1.987–4T(f)(2) provides that the net unrecognized section 987 gain or loss of a separated QBU for a taxable year is determined by taking into account the separated QBU's share of the net accumulated unrecognized section 987 gain or loss of the separating QBU for all prior taxable years for which the final regulations apply and treating the separating QBU as having separated immediately prior to the beginning of the taxable year of separation. No transactions are deemed to occur between the separating QBUs in the taxable year of separation prior to the completion of the separation. A separated QBU's share of the separating QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is determined by apportioning the separating QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years to each separated QBU in proportion to the aggregate adjusted basis of the gross assets properly reflected on the books and records of each separated QBU immediately after the separation.

The temporary regulations also clarify at § 1.987–2T(c)(9)(ii) that, if a combining section 987 QBU has a different functional currency than the combined QBU, the combining section 987 QBU will be deemed to have automatically changed its functional currency to the functional currency of the combined section 987 QBU immediately prior to the combination. A combining section 987 QBU that is deemed to change its functional currency under this paragraph must make the adjustments described in § 1.985–5.

7. *Translation of Foreign Taxes Claimed as a Foreign Tax Credit and Related Income*

Under the general rule of § 1.987–3(c)(1), the owner of a section 987 QBU uses the yearly average exchange rate (as defined in § 1.987–1(c)(2)) to translate an item of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency. Alternatively, the owner of a section 987 QBU may elect to use the spot rate (as defined in § 1.987–1(c)(1)) for the day each item is taken into account.

Under section 986(a)(1)(A), for purposes of determining the amount of its foreign tax credit, a taxpayer that takes foreign income taxes into account when accrued generally translates the amount of any foreign income taxes (and any adjustments thereto) into dollars using the average exchange rate for the taxable year to which such taxes relate. However, sections 986(a)(1)(B) and (C) contain exceptions to this general rule, including for taxes that are not paid within two years of the close of the taxable year to which the taxes relate (two-year rule). In addition, section 986(a)(1)(D) provides that a taxpayer may elect to translate foreign income taxes denominated in a functional currency other than the taxpayer's functional currency using a spot rate in lieu of using the yearly average exchange rate. Section 986(a)(2)(A) generally provides that, for purposes of determining the amount of the foreign tax credit with respect to any foreign income taxes not subject to section 986(a)(1)(A) (or section 986(a)(1)(E), which provides a special rule for regulated investment companies), including by reason of the two-year rule or an election under section 986(a)(1)(D), the taxes are translated into dollars using the spot rate on the date such taxes were paid. Adjustments to such taxes are subject to the same rule, except that any refund or credit is translated into dollars using the exchange rate that applied to the original payment of such foreign income taxes.

Taking into account the translation rules of § 1.987–3(c) and section 986(a), a mismatch could arise between the owner functional currency value of income used to pay foreign income taxes and the owner functional currency value of the foreign income taxes claimed as a credit. In the case of foreign income taxes deemed paid under section 902, section 78 generally prevents such a mismatch at the level of the domestic shareholder claiming the credit by requiring the domestic shareholder to include in income an amount equal to the taxes deemed paid, but where a U.S. person claims a credit under section 901 that is not for taxes deemed paid under section 902 or section 960, foreign income taxes and the income used to pay those taxes could be translated at different translation rates. To address this potential mismatch, Notice 89–74, 1989–1 C.B. 739, provides that when a U.S. taxpayer with a foreign branch that has a functional currency other than the dollar claims a foreign tax credit with respect to a foreign tax, the taxpayer is required to translate a functional currency amount equal to the foreign taxes paid on branch income using the exchange rate at the time of payment of such taxes.

Consistent with Notice 89–74, § 1.987–3T(c)(2)(v) includes a special translation rule providing that income in an amount equal to the functional currency amount of the section 987 QBU's foreign income taxes claimed as a credit must be translated at the same rate used to translate the taxes. This translation rule applies to the owner of a section 987 QBU claiming a credit under section 901 for foreign income taxes, other than income taxes deemed paid under section 902 or section 960, that are properly reflected on the books of the section 987 QBU. Mechanically, this rule requires the owner to reduce the amount of section 987 taxable income or loss that otherwise would be determined under § 1.987–3 by an amount equal to the creditable tax amount, translated into U.S. dollars at the yearly average exchange rate for the taxable year in which the creditable tax is accrued, and then to increase the resulting amount by an amount equal to the creditable tax amount translated into U.S. dollars at the same exchange rate used to translate the creditable taxes into U.S. dollars under section 986(a). If the foreign taxes and the income are both translated at the same rate (that is, the same yearly average exchange rate), no adjustment is necessary under § 1.987–3T(c)(2)(v).

8. *Determination of a Partner's Share of Assets and Liabilities of a Section 987 Aggregate Partnership*

As discussed in the preamble to the final regulations, the final regulations apply an aggregate approach with respect to section 987 aggregate partnerships, which are defined in § 1.987–1(b)(5) as partnerships for which all of the capital and profits interests are owned, directly or indirectly, by persons that are related within the meaning of section 267(b) or section 707(b). This approach is consistent with the aggregate approach to partnerships reflected in the 2006 proposed regulations, but the 2006 proposed regulations would have applied to all partnerships. Under the aggregate approach, assets and liabilities reflected on the books and records of an eligible QBU of a partnership are allocated to each partner, which is considered an indirect owner of the eligible QBU. If the eligible QBU has a different functional currency than its indirect owner, then the assets and liabilities of the eligible QBU that are allocated to the partner are treated as a section 987 QBU of the indirect owner.

The 2006 proposed regulations provided a rule for determining a partner's share of the assets and liabilities of an eligible QBU that is owned indirectly through a section 987 aggregate partnership. Specifically, proposed § 1.987–7(b) provided that a partner's share of assets and liabilities reflected on the books and records of an eligible QBU owned through a section 987 aggregate partnership must be determined in a manner consistent with how the partners have agreed to share the economic benefits and burdens corresponding to partnership assets and liabilities, taking into account the rules and principles of subchapter K. One comment noted that this rule for allocating assets and liabilities to a partner's indirectly owned section 987 QBU was ambiguous and that the rules and principles of subchapter K do not provide sufficient guidance in this regard.

The Treasury Department and the IRS acknowledge the ambiguity in the 2006 proposed regulations regarding the manner in which assets and liabilities of a partnership are allocated to a partner's indirectly owned section 987 QBU under the aggregate approach. Accordingly, the temporary regulations provide more specific rules for determining a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership. Specifically, § 1.987–7T(b) provides that, in any taxable year, a partner's share of each asset and liability of a section 987 aggregate partnership is proportional to the partner's liquidation value percentage with respect to the aggregate partnership. A partner's liquidation value percentage is defined as the ratio of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of the partner's interest in the partnership is the amount of cash the partner would receive with respect to its interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752–7), paid an unrelated third party to assume all of its § 1.752–7 liabilities in a fully taxable transaction, and then liquidated.

In general, the temporary regulations provide that the determination date for determining a partner's liquidation value percentage is the date of the most recent event described in § 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (a revaluation event), irrespective of whether the capital accounts of the partners are adjusted under § 1.704–1(b)(2)(iv)(*f*), or, if there has been no revaluation event, the date of the formation of the partnership. However, if a partnership agreement provides for the allocation of any item of income, gain, deduction, or loss from partnership property to a partner other than in accordance with the partner's liquidation value percentage in a particular taxable year, the determination date is the last day of the partner's taxable year, or, if the partner's section 987 QBU owned indirectly through a section 987 aggregate partnership terminates during the partner's taxable year, the date such section 987 QBU is terminated. Without this requirement to redetermine liquidation value percentages at year-end when such an allocation is in effect, the allocation could result in section 987 taxable income or loss, which necessarily would reflect the allocation, being taken into account in determining section 987 gain or loss under § 1.987–4 even though the allocation was not taken into account in computing the owner functional currency value of the section 987 QBU, such that distortions would arise in the computation of section 987 gain or loss.

The Treasury Department and the IRS have determined that the liquidation value percentage methodology reflected in § 1.987–7T(b) reflects an administrable approach to allocating assets and liabilities of a section 987 aggregate partnership to eligible QBUs of its partners in a manner consistent with the partners' economic interests in the assets and liabilities of the partnership. The Treasury Department and the IRS request comments on the application of the liquidation value percentage approach reflected in the temporary regulations, including whether any alternative measure could better satisfy the criteria of administrability and consistency with the economics of the partners' arrangement.

9. *Deferral of Certain Section 988 Loss Realized by a Debtor with Respect to a Related-party Loan*

Section 267(a)(1) provides that no deduction is allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons who have a relationship described in section 267(b). Section 267(f)(2) modifies the general rule of section 267(a)(1) in the case of a sale or exchange of property between corporations that are members of the same controlled group (as defined in section 267(f)(1)), generally providing that a loss realized upon such a sale or exchange is deferred until the property is transferred outside the group such that there would be recognition of loss under consolidated return principles. Section 267(f)(3)(C) provides that, to the extent provided in regulations, section 267(a)(1) does not apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of such controlled group if such loan is payable or denominated in a foreign currency and attributable to a reduction in the value of that foreign currency. Section 1.267(f)–1(e) provides that section 267(a) generally does not apply to an exchange loss realized with respect to a loan of nonfunctional currency to another controlled group member if the transaction that causes the realization of the loss does not have as a significant purpose the avoidance of Federal income tax. Additionally, § 1.267(f)–1(h) provides that if a transaction is engaged in with a principal purpose to avoid the purposes of § 1.267(f)–1, including by distorting the timing of losses, adjustments may be made to carry out such purposes. Section 1.988–2(b)(16)(i) cross-references the regulations under section 267 regarding the coordination of sections 267 and 988 with respect to the treatment of a creditor under a debt instrument, but § 1.988–2(b)(16)(ii) is reserved with respect to the treatment of a debtor. The temporary regulations correct the cross-reference in § 1.988–2(b)(16)(i) to refer to § 1.267(f)–1(e) rather than § 1.267(f)–1(h).

The Treasury Department and the IRS have determined that the policy considerations underlying section 267(f)(3)(C) and § 1.267(f)–1(e) with respect to creditors on loans to related persons also apply with respect to debtors on such loans and that there is no reason to distinguish between a creditor and debtor with regard to the application of an anti-avoidance rule to the same transaction. Accordingly, pursuant to the authority granted to the Secretary in section 989(c)(5) to prescribe regulations providing for the appropriate treatment of related-party transactions, § 1.988–2T(b)(16)(ii) provides that exchange loss of a debtor with respect to a loan (original loan) from a person with whom the debtor has a relationship described in section 267(b) or section 707(b) is deferred if the transaction resulting in realization of the loss has a principal purpose of avoiding Federal income tax. Such deferred loss will be recognized at the end of the term of the original loan.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), please refer to the Special Analyses section in the preamble to the cross-referenced notice of proposed rulemaking in the Proposed Rules section of this issue of the **Bulletin.** Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Mark E. Erwin of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

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Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 985, 987, 989(c) and 7805 * * *

Par. 2. Section 1.987–0 is amended by adding entries for §§ 1.987–6(b)(4)and 1.987–12(a) through (h) to read as follows:

§ 1.987–0 Section 987; table of contents.

* * * * *

§ 1.987–6 Character and source of section 987 gain or loss.

* * * * *

(b) * * *

(4) [Reserved].

* * * * *

§ 1.987–12 Deferral of section 987 gain or loss.

(a) through (h) [Reserved].

Par. 3. Section 1.987–1 is amended by adding paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(B) and (C), and (g)(3)(i)(E) through (H) to read as follows:

§ 1.987–1 Scope, definitions, and special rules.

* * * * *

(b) * * *

(1) * * *

(iii) [Reserved]. For further guidance, see § 1.987–1T(b)(1)(iii).

* * * * *

(b) * * *

(6) [Reserved]. For further guidance, see § 1.987–1T(b)(6).

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(B) [Reserved]. For further guidance, see § 1.987–1T(c)(1)(ii)(B).

* * * * *

(c) * * *

(3) * * *

(i) * * *

(E) [Reserved]. For further guidance, see § 1.987–1T(c)(3)(i)(E).

* * * * *

(d) * * *

(3) [Reserved]. For further guidance, see § 1.987–1T(d)(3).

* * * * *

(f) [Reserved]. For further guidance, see § 1.987–1T(f).

* * * * *

(g) * * *

(2) * * *

(i) * * *

(B) through (C) [Reserved]. For further guidance, see § 1.987–1T(g)(2)(i)(B) through (C).

* * * * *

(g) * * *

(3) * * *

(i) * * *

(E) through (H) [Reserved]. For further guidance, see § 1.987–1T(g)(3)(i)(E) through (H).

* * * * *

Par. 4. Section 1.987–1T is added to read as follows:

§ 1.987–1T Scope, definitions, and special rules (temporary).

(a) through (b)(1)(ii) [Reserved]. For further guidance, see § 1.987–1(a) through (b)(1)(ii).

(iii) *Certain provisions applicable to all taxpayers*. Notwithstanding § 1.987–1(b)(1)(ii), paragraphs (b)(6) and (g)(3)(i)(E) of this section and § 1.987–6T(b)(4) apply to any taxpayer that is an owner of a dollar QBU (as defined in paragraph (b)(6) of this section), and paragraphs (g)(2)(i)(B) and (g)(3)(i)(H) of this section and §§ 1.987–8T(d) and 1.987–12T apply to any taxpayer that is an owner of an eligible QBU (determined without regard to § 1.987–1(b)(3)(ii)) that is subject to section 987.

(b)(2) through (b)(5) [Reserved]. For further guidance, see § 1.987–1(b)(2) through (b)(5).

(6) *Dollar QBUs*—(i) *In general*. Except as provided in paragraphs (b)(1)(iii) and (b)(6)(iii) of this section, section 987 and the regulations thereunder do not apply with respect to an eligible QBU (determined without regard to § 1.987–1(b)(3)(ii)) that has the U.S. dollar as its functional currency and that would be subject to section 987 if it had a functional currency other than the dollar (dollar QBU). This paragraph (b)(6) applies to all taxpayers, including entities described in § 1.987–1(b)(1)(ii).

(ii) *Application of section 988 to a dollar QBU*—(A) *In general*. Except as provided in paragraphs (b)(6)(ii)(B) and (b)(6)(iii) of this section, a controlled foreign corporation (as defined in section 957(a)) (CFC) that is the owner of a dollar QBU applies section 988 with respect to any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU. Except as provided in paragraph (b)(6)(ii)(B) of this section, for purposes of determining the amount of section 988 gain or loss of the CFC, any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU is treated as properly reflected on the books and records of the owner of the dollar QBU, such that the amount of section 988 gain or loss with respect to such item is determined by reference to the owner's functional currency.

(B) *Section 988 gain or loss characterized as effectively connected income*. Solely for the purpose of determining the amount of section 988 gain or loss of a CFC described in paragraph (b)(6)(ii)(A) of this section that is effectively connected with the conduct of a trade or business within the United States (ECI), any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under § 1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar.

(iii) *Election for a CFC to apply section 987 to a dollar QBU*—(A) *In general*. A CFC that is the owner of a dollar QBU may elect to apply section 987 and the regulations thereunder with respect to the dollar QBU in lieu of applying section 988 pursuant to paragraph (b)(6)(ii) of this section. If the dollar QBU or CFC is described in § 1.987–1(b)(1)(ii), however, the CFC must apply section 987 to the dollar QBU using the method it applied to the dollar QBU immediately prior to the effective date of this paragraph (b)(6) as provided in paragraph (h) of this section, provided such method was a reasonable interpretation of section 987, or, if no such method exists, a reasonable method.

(B) *Section 988 gain or loss characterized as effectively connected income*. Solely for the purpose of determining the amount of section 988 gain or loss of a dollar QBU that is the subject of an election described in paragraph (b)(6)(iii)(A) of this section that is ECI, § 1.987–3T(b)(4)(i) and (ii) do not apply, and any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under § 1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar. See § 1.987–6T(b)(4) for rules regarding the source of section 987 gain or loss with respect to a dollar QBU for which the CFC owner has made the election described in this paragraph.

(b)(7) through (c)(1)(ii)(A) [Reserved]. For further guidance, see § 1.987–1(b)(7) through (c)(1)(ii)(A).

(B) *Election inapplicable with respect to certain amounts*. Except as provided in this paragraph (c)(1)(ii)(B), the election provided in § 1.987–1(c)(1)(ii)(A) does not apply for purposes of determining section 987 taxable income or loss (as defined in § 1.987–3(a)) with respect to a historic item (as defined in § 1.987–1(e)) if acquiring, accruing, or entering into such item gives rise to a section 988 transaction or specified owner functional currency transaction. However, the election provided in § 1.987–1(c)(1)(ii)(A) does apply for purposes of determining section 987 taxable income or loss with respect to a payable or receivable described in § 1.988–1(d)(3) under the circumstances described in § 1.988–1(d)(3).

(c)(2) through (c)(3)(i)(D) [Reserved]. For further guidance, see § 1.987–1(c)(2) through (c)(3)(i)(D).

(E) *Section 988 transactions and specified owner functional currency transactions*. If acquiring, accruing, or entering into a historic item gives rise to a section 988 transaction of a section 987 QBU or a specified owner functional currency transaction described in § 1.987–3T(b)(4)(ii), the historic rate is the spot rate (as defined in paragraph (c)(1) of this section) on the date such item is acquired, accrued, or entered into. For this purpose, use of a spot rate convention under § 1.987–1(c)(1)(ii) is permitted only with respect to a payable or receivable described in § 1.988–1(d)(3) and only to the extent provided therein.

(c)(3)(ii) through (d)(2) [Reserved]. For further guidance, see § 1.987–1(c)(3)(ii) through (d)(2).

(3) Gives rise to a qualified short-term section 988 transaction (as defined in § 1.987–3T(b)(4)(iii)(B)) of the section 987 QBU, whether denominated in the functional currency of the owner or other nonfunctional currency with respect to the section 987 QBU, for which section 988 gain or loss is determined under § 1.987–3T(b)(4)(iii)(A) in, and by reference to, the functional currency of the section 987 QBU.

(e) [Reserved]. For further guidance, see § 1.987–1(e).

(f) *Examples*. The following examples illustrate the application of § 1.987–1(d) and (e).

Example 1. U.S. Corp is a domestic corporation with the U.S. dollar as its functional currency and is the owner of Business A, a section 987 QBU that has the pound as its functional currency. Assume all transactions of Business A are entered into in the ordinary course of its business. U.S. Corp has not made an election under § 1.987–3T(b)(4)(iii)(C) to adopt a foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions. Items reflected on Business A's balance sheet include £10,000, $1,000, a building with a basis of £100,000, a light general purpose truck with a basis of £30,000, a computer with a basis of £1,000, a 60-day receivable for ¥15,000, an account payable of £5,000, and a foreign currency contract within the meaning of section 1256(g)(2) that requires Business A to exchange £100 for $125 in 90 days. Under paragraph (d) of this section, the £10,000, the £5,000 account payable and the £/$ section 1256 foreign currency contract are marked items. The other items are historic items under this paragraph (e) of this section.

Example 2. The facts are the same as *Example 1* except that U.S. Corp has elected under § 1.987–3T(b)(4)(iii)(C) to adopt the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions of Business A. Under paragraphs (d) and (e) of this section, the £10,000, the $1,000, the ¥15,000 receivable, the £5,000 account payable, and the £/$ section 1256 foreign currency contract are marked items.

(g)(1) through (g)(2)(i)(A) [Reserved]. For further guidance, see § 1.987–1(g)(1) through (g)(2)(i)(A).

(B) *Annual deemed termination election*—(*1*) *In general*. Except as provided in paragraph (g)(2)(i)(B)(*2*) of this section, an election under § 1.987–8T(d) (annual deemed termination election) applies to all section 987 QBUs owned by the taxpayer, as well as to all section 987 QBUs owned by any person that has a relationship to the taxpayer described in section 267(b) or section 707(b) (substituting "and the profits interest" for "or the profits interest" in section 707(b)(1)(A) and substituting "and profits interests" for "or profits interests" in section 707(b)(1)(B)) on the last day of the first taxable year for which the election applies (a related person). If a taxpayer makes the election under § 1.987–8T(d), the first taxable year of a related person for which the election applies is the first taxable year that ends with or within a taxable year of the taxpayer for which the taxpayer's election applies. An election under § 1.987–8T(d) may not be revoked.

(*i*) *Fresh start taxpayers*. A taxpayer to which § 1.987–10 applies that is required under § 1.987–10(a) to apply the fresh start transition method described in § 1.987–10(b) (fresh start taxpayer) may make the election under § 1.987–8T(d) only if the first taxable year for which the election would apply to the taxpayer is either the first taxable year beginning on or after the transition date (as defined in § 1.987–11(c)) in which the election is relevant or a subsequent taxable year in which the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million. For purposes of this paragraph (g)(2)(i)(B), a taxpayer's controlled group aggregate section 987 loss means the aggregate net amount of section 987 loss that would be recognized pursuant to the election by the taxpayer and all other persons to whom the taxpayer's election would apply in the first taxable year of each person for which the election would apply.

(*ii*) *Other taxpayers*. Other taxpayers, including taxpayers described in § 1.987–1(b)(1)(ii) and taxpayers described in § 1.987–10(c), must follow the election rules provided in paragraph (g)(2)(i)(B)(*1*)(*i*) of this section if any related party is a fresh start taxpayer. If no related party is a fresh start taxpayer, the election under § 1.987–8T(d) may be made only if the first taxable year for which the election would apply to the taxpayer is either the first taxable year beginning on or after December 7, 2016, in which the election is relevant or a subsequent taxable year in which the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million.

(*2*) *QBU-by-QBU elections in certain circumstances*. Notwithstanding paragraph (g)(2)(i)(B)(*1*) of this section, a taxpayer may make a separate election under § 1.987–8T(d) with respect to any section 987 QBU owned by the taxpayer if the first taxable year for which the election would apply to the taxpayer with respect to the section 987 QBU is a taxable year in which there is a section 987 gain recognized with respect to the section 987 QBU pursuant to the election, or is a taxable year in which there is a section 987 loss of $1 million or less that would be recognized with respect to the section 987 QBU pursuant to the election

(C) *Election to translate all items at the yearly average exchange rate*. An election under § 1.987–3T(d) (election to translate all items at the yearly average exchange rate) may be made with respect to a section 987 QBU only if the first taxable year for which the election would apply is the first taxable year for which an election under § 1.987–8T(d) (annual deemed termination election) applies with respect to the section 987 QBU.

(g)(2)(ii) through (g)(3)(i)(D) [Reserved]. For further guidance, see § 1.987–1(g)(2)(ii) through (g)(3)(i)(D).

(E) *Election for a CFC to apply section 987 to a dollar QBU*. An election under § 1.987–1T(b)(6)(iii) for a CFC to apply section 987 to a dollar QBU must be titled "Section 987 Election for a CFC to Apply Section 987 to a Dollar QBU Under § 1.987–1T(b)(6)(iii)" and must provide the name and address of each QBU for which the election is being made.

(F) *Election to apply the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions*. An election under § 1.987–3T(b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions must be titled "Section 987 Election to Use Foreign Currency Mark-to-Market Method of Accounting for Qualified Short-Term Section 988 Transactions Under § 1.987–3(b)T(4)(iii)(C)" and must provide the name and address of each section 987 QBU for which the election is being made.

(G) *Election to translate all items at the yearly average exchange rate*. An election under § 1.987–3T(d) to translate all items at the yearly average exchange rate must be titled "Section 987 Election to Translate All Items at the Yearly Average Exchange Rate Under § 1.987–3T(d)" and must provide the name and address of each section 987 QBU for which the election is being made.

(H) *Annual deemed termination election*. An election under § 1.987–8T(d) for an owner to deem all of its section 987 QBUs to terminate on the last day of each taxable year must be titled "Section 987 Annual Deemed Termination Election Under § 1.987–8T(d)" and must provide the name and address of each section 987 QBU to which the election applies, including a section 987 QBU owned by a related person (within the meaning of paragraph (g)(2)(i)(B)(*1*) of this section).

(g)(4) through (6) [Reserved]. For further guidance, see § 1.987–1(g)(4) through (6).

(h) *Effective/applicability date*. Paragraphs (g)(2)(i)(B) and (g)(3)(i)(H) of this section apply to the first taxable year beginning on or after December 7, 2016. Paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(C), and (g)(3)(i)(E) through (G) of this section apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(C), and (g)(3)(i)(E) through (G) of this section apply to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(i) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 5. Section 1.987–2 is amended by adding paragraph (c)(9) to read as follows:

§ 1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

* * * * *

(c) * * *

(9) [Reserved]. For further guidance, see § 1.987–2T(c)(9).

* * * * *

Par. 6. Section 1.987–2T is added to read as follows:

§ 1.987–2T Attribution of items to eligible QBUs; definition of a transfer and related rules (temporary).

(a) through (c)(8) [Reserved]. For further guidance, see § 1.987–2(a) through (c)(8).

(9) *Certain disregarded transactions not treated as transfers*—(i) *Combinations of section 987 QBUs*. The combination of two or more separate section 987 QBUs (combining QBUs) that are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, into one section 987 QBU (combined QBU) does not give rise to a transfer of any combining QBU's assets or liabilities to the owner under § 1.987–2(c). In addition, transactions between the combining QBUs occurring in the taxable year of the combination do not result in a transfer of the combining QBUs' assets or liabilities to the owner under § 1.987–2(c). For this purpose, a combination occurs when the assets and liabilities that are properly reflected on the books and records of two or more combining QBUs begin to be properly reflected on the books and records of a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which the combining QBUs become a combined QBU. For rules regarding the determination of net unrecognized section 987 gain or loss of a combined QBU, see § 1.987–4T(f)(1).

(ii) *Change in functional currency from a combination*. If, following a combination of section 987 QBUs described in paragraph (c)(9)(i) of this section, the combined section 987 QBU has a different functional currency than one or more of the combining section 987 QBUs, any such combining section 987 QBU is treated as changing its functional currency and the owner of the combined section 987 QBU must comply with the regulations under section 985 regarding the change in functional currency. See §§ 1.985–1(c)(6) and 1.985–5.

(iii) *Separation of section 987 QBUs*. The separation of a section 987 QBU (separating QBU) into two or more section 987 QBUs (separated QBUs) that, after the separation, are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, does not give rise to a transfer of the separating QBU's assets or liabilities to the owner under § 1.987–2(c). Additionally, transactions that occurred between the separating QBUs in the taxable year of the separation prior to the completion of the separation do not give rise to transfers for purposes of section 987. For this purpose, a separation occurs when the assets and liabilities that are properly reflected on the books and records of a separating QBU begin to be properly reflected on the books and records of two or more separated QBUs. A separation may result from any transaction or series of transactions in which a separating QBU becomes two or more separated QBUs. A separation may also result when a section 987 QBU that is subject to a grouping election under § 1.987–1(b)(2)(ii)(A) changes its functional currency. For rules regarding the determination of net unrecognized section 987 gain or loss of a separated QBU, see § 1.987–4T(f)(2).

(c)(10) through (d) [Reserved]. For further guidance see § 1.987–2(c)(10) through (d).

(e) *Effective/applicability date*. This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(f) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 7. Section 1.987–3 is amended by adding paragraphs (b)(2)(ii), (b)(4), (c)(2)(ii) and (v), and (d), and *Example 9* through *Example 14* at the end of paragraph (e) to read as follows:

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

* * * * *

(b) * * *

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.987–3T(b)(2)(ii).

* * * * *

(b) * * *

(4) [Reserved]. For further guidance, see § 1.987–3T(b)(4).

* * * * *

(c) * * *

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.987–3T(c)(2)(ii).

* * * * *

(c) * * *

(2) * * *

(v) through (d) [Reserved]. For further guidance, see § 1.987–3T(c)(2)(v) through (d).

(e) *Examples*. * * *

Example 9 through *Example 14* [Reserved]. For further guidance, see § 1.987–3T(e), *Example 9* through *Example 14*.

Par. 8. Section 1.987–3T is added to read as follows:

§ 1.987–3T Determination of section 987 taxable income or loss of an owner of a section 987 QBU (temporary).

(a) through (b)(2)(i) [Reserved]. For further guidance, see § 1.987–3(a) through (b)(2)(i).

(ii) *No translation of basis or amount realized with respect to a specified owner functional currency transaction treated as a historic asset*. If the acquisition of a historic asset gives rise to a specified owner functional currency transaction described in paragraph (b)(4)(ii) of this section, the basis of the historic asset, and any amount realized on a disposition of the historic asset, is not translated if the amount is denominated in the owner's functional currency.

(3) [Reserved]. For further guidance, see § 1.987–3(b)(3).

(4) *Special rule for section 988 transactions*—(i) *In general*. Section 988 and the regulations thereunder apply to section 988 transactions of a section 987 QBU. For this purpose, whether a transaction is a section 988 transaction is determined by reference to the functional currency of the section 987 QBU. (But see paragraph (b)(4)(ii) of this section, providing that specified owner functional currency transactions are not treated as section 988 transactions.) However, except as provided in paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss is determined in, and by reference to, the functional currency of the owner of the section 987 QBU rather than the functional currency of the section 987 QBU. Accordingly, in determining section 988 gain or loss of a section 987 QBU with respect to a section 988 transaction of the section 987 QBU, the amounts required under section 988 and the regulations thereunder to be translated on the applicable booking date or payment date with respect to the section 988 transaction are translated into the owner's functional currency at the rate required under section 988 and the regulations thereunder.

(ii) *Specified owner functional currency transactions not treated as section 988 transactions*. Transactions of a section 987 QBU described in sections 988(c)(1)(B)(i), 988(c)(1)(B)(ii), and 988 (c)(1)(C) (including the acquisition of nonfunctional currency as described in § 1.988–1(a)(1)), other than transactions described in paragraph (b)(4)(iii)(A) of this section, that are denominated in (or determined by reference to) the owner's functional currency (specified owner functional currency transactions) are not treated as section 988 transactions. Thus, no currency gain or loss is recognized by a section 987 QBU under section 988 with respect to such transactions.

(iii) *Determination of section 988 gain or loss for qualified short-term section 988 transactions*—(A) *Determination by reference to the section 987 QBU's functional currency for certain transactions subject to a mark-to-market method of accounting*. Section 988 gain or loss with respect to section 988 transactions described in paragraph (b)(4)(iii)(B) of this section that are accounted for under a mark-to-market method of accounting for Federal income tax purposes or under the foreign currency mark-to-market method of accounting described in paragraph (b)(4)(iii)(C) of this section, and any hedges entered into to manage risk with respect to such transactions within the meaning of § 1.1221–2(c)(4) (related hedges), must be determined in, and by reference to, the functional currency of the section 987 QBU (rather than the functional currency of its owner).

(B) *Qualified short-term section 988 transaction*. A qualified short-term section 988 transaction is a section 988 transaction that occurs in the ordinary course of a section 987 QBU's business and has an original term of one year or less on the date the transaction is entered into by the section 987 QBU. The holding of currency that is nonfunctional currency (within the meaning of section 988(c) (1)(C)(ii)) to the section 987 QBU in the ordinary course of a section 987 QBU's trade or business also is treated as a qualified short-term section 988 transaction. Any transaction that is denominated in, or determined by reference to, a hyperinflationary currency, including the holding of hyperinflationary currency, is not considered a qualified short-term section 988 transaction. See §§ 1.988–2(b)(15), 1.988–2(d)(5), and 1.988–2(e)(7) for rules relating to transactions denominated in, or determined by reference to, a hyperinflationary currency.

(C) *Election to use a foreign currency mark-to-market method of accounting*. A taxpayer may elect under this paragraph (b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting described in this paragraph for all qualified short-term section 988 transactions described in paragraph (b)(4)(iii)(B) of this section, and any related hedges, that are properly attributable to a section 987 QBU on or after the effective date of the election and that are not otherwise accounted for under a mark-to-market method of accounting under section 475 or section 1256. Under the foreign currency mark-to-market method of accounting, the timing of section 988 gain or loss on section 988 transactions is determined under the principles of section 1256(a)(1). Thus, only section 988 gain or loss is taken into account under the foreign currency mark-to-market method of accounting. Appropriate adjustments must be made to prevent the section 988 gain or loss from being taken into account again under section 988 or another provision of the Code or regulations. A section 988 transaction subject to this election is not subject to the "netting rule" of section 988(b) and § 1.988–2(b)(8), under which exchange gain or loss is limited to overall gain or loss realized in a transaction, in taxable years prior to the taxable year in which section 988 gain or loss would be recognized with respect to such section 988 transaction but for this election.

(iv) *Examples*. Examples 10 through 13 of paragraph (e) of this section illustrate the application of this paragraph (b)(4).

(c)(1) through (c)(2)(i) [Reserved]. For further guidance, see § 1.987–3(c)(1) through (c)(2)(i).

(ii) *Amount realized with respect to historic assets that are section 988 transactions*. If the acquisition of a historic asset gave rise to a section 988 transaction described in paragraph (b)(4)(i) of this section, then in computing the total gain or loss on a disposition of the historic asset (some or all of which total gain or loss may be section 988 gain or loss described in section 988(b) and paragraph (b)(4)(i) of this section), the amount realized (determined, if necessary, under § 1.987–3(b)(2)(i)) is translated into the owner's functional currency using the spot rate on the date such item is properly taken into account, subject to the limitation under § 1.987–1T(c)(1)(ii)(B) regarding the use of a spot rate convention.

(iii) through (iv) [Reserved]. For further guidance, see § 1.987–3(c)(2)(iii) through (iv).

(v) *Translation of income to account for certain foreign income tax claimed as a credit*. The owner of a section 987 QBU claiming a credit under section 901 for foreign income taxes, other than foreign income taxes deemed paid under section 902 or section 960, that are properly reflected on the books and records of the section 987 QBU (the creditable tax amount) must determine section 987 taxable income or loss attributable to the section 987 QBU by reducing the amount of section 987 taxable income or loss that otherwise would be determined under this section by an amount equal to the creditable tax amount, translated into U.S. dollars using the yearly average exchange rate for the taxable year in which the creditable tax is accrued, and by increasing the resulting amount by an amount equal to the creditable tax amount, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a). See *Example 14* of paragraph (e) of this section, , for an illustration of this rule.

(d) *Election to translate all items at the yearly average exchange rate*. Notwithstanding § 1.987–3(c), a taxpayer that has made the annual deemed termination election described in § 1.987–8T(d) may elect under this paragraph (d) to translate all items of income, gain, deduction, and loss with respect to a section 987 QBU determined under § 1.987–3(b) in the functional currency of the section 987 QBU into the owner's functional currency, if necessary, at the yearly average exchange rate for the taxable year. *Example 9* of paragraph (e) of this section illustrates the application of this election.

(e) *Example 1* through *Example 8* [Reserved]. For further guidance, see § 1.987–3(e), *Example 1* through *Example 8*.

Example 9. The facts are the same as in *Example 7,* except that U.S. Corp properly elects under paragraph (d) of this section to translate all items of income, gain, deduction, and loss with respect to Business A at the yearly average exchange rate. Accordingly, Business A's €2,000 gain on the sale of the land is translated at the yearly average exchange rate for 2021 of €1 = $1.05, and the amount of gain reported by U.S. Corp on the sale of the land is $2,100.

Example 10. Business A acquires £100 on August 27, 2021, for €120 and sells the pounds on November 17, 2021, for €125. The dollar-pound spot rate (without the use of a spot rate convention) is £1 = $1 on August 27, 2021, and £1 = $1.10 on November 17, 2021. The disposition of the pounds is a section 988 transaction of Business A under paragraph (b)(4)(i) of this section, and the pounds are a historic asset under § 1.987–1(e). Section 988 gain or loss with respect to the disposition of the pounds is determined under paragraph (b)(4)(i) of this section and § 1.988–2(a)(2) by reference to the dollar functional currency of Business A's owner. The dollar amount realized for the pounds is determined under paragraph (c)(2)(ii) of this section by translating £100 into $110 using the dollar-pound spot rate on November 17, 2021, without the use of a spot rate convention. The dollar basis in the pounds is determined under § 1.987–3(c)(2)(i) by translating £100 into $100 using the historic rate described in § 1.987–1T(c)(3)(i)(E), which is the dollar-pound spot rate on August 27, 2021, without the use of a spot rate convention. Thus, U.S. Corp takes into account $10 of section 988 gain with respect to Business A's disposition of £100.

Example 11. (i) Business A purchases a £100 2-year note for €75 on October 1, 2021, and receives a £100 repayment of principal with respect to the note on December 31, 2021. At the spot rates on October 1, 2021 (as defined in § 1.987–1(c)(1)), without the use of a spot rate convention, Business A's €75 purchase price translates into £80 and $95. At the spot rates on December 31, 2021, without the use of a spot rate convention, the £100 principal amount on the note translates into €90 and $130, and £80 translates into $104.

(ii) The acquisition of the note is a section 988 transaction of Business A under paragraph (b)(4)(i) of this section, and the note is a historic asset under § 1.987–1(e). To determine its section 987 taxable income or loss with respect to Business A, U.S. Corp must determine Business A's total gain or loss on the disposition of the note in U.S. Corp's dollar functional currency. Consistent with § 1.988–2(b)(8), U.S. Corp also must determine whether some or all of that gain or loss constitutes section 987 gain or loss described in section 988(b).

(iii) To determine Business A's total gain or loss on the disposition of the note, Business A's basis and amount realized on the note must be determined in euros under § 1.987–3(b), if necessary, and translated into dollars under § 1.987–3(c). Business A has a €75 basis in the note that is translated into $95 under § 1.987–3(c)(2)(i) at the historic rate described in § 1.987–1T(c)(3)(i)(E), which is the spot rate on the date the note was acquired without the use of a spot rate convention. Business A's £100 amount realized on the note is translated into €90 under § 1.987–3(b)(2)(i) using the spot rate on December 31, 2021, without the use of a spot rate convention. That €90 amount realized is then translated into $130 under paragraph (c)(2)(ii) of this section using the spot rate on December 31, 2021, without the use of a spot rate convention. Accordingly, the total gain with respect to the disposition of the note that is included in section 987 taxable income is $35 ($130 less $95).

(iv) U.S. Corp must determine whether some or all of the $35 total gain with respect to the note constitutes section 988 gain. The amount of section 988 gain realized with respect to the note is determined under § 1.988–2(b)(5), which requires a comparison of the functional currency value of the principal amount of the note on the booking date and payment date spot rates, respectively, and defines the principal amount of the note as Business A's purchase price in units of nonfunctional currency, which is £80. Under paragraph (b)(4)(i) of this section, section 988 gain or loss with respect to the note is determined by reference to U.S. Corp's dollar functional currency, such that the amounts required under section 988 to be translated on the booking date and payment date are translated into the dollars at the booking date and payment date spot rates. Accordingly, Business A's £80 principal amount with respect to the note is translated at the booking date and payment date spots rates into $95 and $104, respectively. Thus, $9 ($104 less $95) of the $35 total gain taken into account by U.S. Corp as section 987 taxable income with respect to the note is section 988 gain. The remaining $26 of gain, which may be attributable to credit risk or another factor unrelated to currency fluctuations, is sourced and characterized without regard to section 988.

Example 12. The facts are the same as in *Example 11*, except that Business A is owned by a foreign corporation with a pound functional currency. Under paragraph (b)(4)(ii) of this section, the acquisition of the £100 2-year note is a specified owner functional currency transaction that is not treated as a section 988 transaction of Business A. Because the note is a historic asset under § 1.987–1(e), Business A's €75 basis in the note translates into £80 at the historic rate described in § 1.987–1T(c)(3)(i)(E), which provides that the historic rate is the spot rate for the date the note was acquired without the use of a spot rate convention. (If, instead, Business A had purchased the 5-year note for £80 rather than €75, then pursuant to paragraph (b)(2)(ii) of this section, Business A's basis in the note would have been determined without translating the £80 purchase price because it is denominated in the owner's functional currency.) Under paragraph (b)(2)(ii) of this section, the £100 amount realized with respect to the note is not translated because it is denominated in the owner's functional currency. Thus, the owner takes into account £20 (£100 less £80) of section 987 taxable income in 2021 with respect to the note.

Example 13. (i) Business A receives and accrues $100 of income from the provision of services on January 1, 2021. Business A continues to hold the $100 as a U.S. dollar-denominated demand deposit at a bank on December 31, 2021. U.S. Corp has elected under paragraph (b)(4)(iii)(C) of this section to use the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions entered into by Business A. The euro-dollar spot rate without the use of a spot rate convention is €1 = $1 on January 1, 2021, and €1 = $2 on December 31, 2021, and the yearly average exchange rate for 2021 is €1 = $1.50.

(ii) Under § 1.987–3(b)(2)(i), the $100 earned by Business A is translated into €100 at the spot rate on January 1, 2021, as defined in § 1.987–1(c)(1) without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €100 of service income is translated into $150 at the yearly average exchange rate for 2021, as provided in § 1.987–3(c)(1).

(iii) The $100 demand deposit constitutes a qualified short-term section 988 transaction under paragraph (b)(4)(iii)(B) of this section because the demand deposit is treated as nonfunctional currency within the meaning of section 988(c)(1)(C)(ii). Because Business A uses the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions, under paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss for such transactions is determined in, and by reference to, euros, the functional currency of Business A. Accordingly, section 988 gain or loss must be determined on Business A's holding of the $100 demand deposit in, and by reference to, the euro. Under § 1.988–2(a)(2), Business A is treated as having an amount realized of €50 when the $100 is marked to market at the end of 2021 under paragraph (b)(4)(iii)(C) of this section. Marking the dollars to market gives rise to a section 988 loss of €50 (€50 amount realized, less Business A's €100 basis in the $100). In determining U.S. Corp's taxable income, that €50 loss is translated into a $75 loss at the yearly average exchange rate for 2021, as provided in § 1.987–3(c)(1).

Example 14. (i) *Facts*. Business A earns €100 of revenue from the provision of services and incurs €30 of general expenses and €10 of depreciation expense during 2021. Except as otherwise provided, U.S. Corp uses the yearly average exchange rate described in § 1.987–1(c)(2) to translate items of income, gain, deduction, and loss of Business A. Business A is subject to income tax in Country X at a 25 percent rate. U.S. Corp claims a credit with respect to Business A's foreign income taxes and elects under section 986(a)(1)(D) to translate the foreign income taxes at the spot rate on the date the taxes were paid. The yearly average exchange rate for 2021 is €1 = $1.50. The historic rate used to translate the depreciation expense is €1 = $1.00. The spot rate on the date that Business A paid its foreign income taxes was €1 = $1.60.

(ii) *Analysis*. Because U.S. Corp has elected to translate foreign income taxes at the spot rate on the date such taxes were paid rather than at the yearly average exchange rate, U.S. Corp must make the adjustments described in paragraph (c)(2)(v) of this section. Accordingly, U.S. Corp determines its section 987 taxable income by reducing the section 987 taxable income or loss that otherwise would be determined under this section by €15, translated into U.S. dollars at the yearly average exchange rate (€1 = $1.50), and increasing the resulting amount by €15, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a) (€1 = $1.60). Following these adjustments, Business A's section 987 taxable income for 2021 is $96.50, computed as follows:

	Amount in €	*Translation Rate*	*Amount in $*
Revenue	€100	€1 = $1.50	$150.00
General Expenses	(30)	€1 = $1.50	(45.00)
Depreciation	*(10)*	€1 = $1.00	*(10.00)*
Tentative section 987 taxable income	€60		$95.00
Adjustments under paragraph (c)(2)(v) of this section:			
Decrease by €15 tax translated at yearly average exchange rate (€1 = $1.50)			($22.50)
Increase by €15 tax translated at spot rate on payment date (€1 = $1.60)			*24.00*
Section 987 taxable income			$96.50

(f) *Effective/applicability date*. This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(g) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 9. Section 1.987–4 is amended by adding paragraphs (c)(2) and (f) to read as follows:

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

* * * * *

(c) * * *

(2) [Reserved]. For further guidance, see § 1.987–4T(c)(2).

* * * * *

(f) [Reserved]. For further guidance, see § 1.987–4T(f).

* * * * *

Par. 10. Section 1.987–4T is added to read as follows:

§ 1.987–4T Determination of net unrecognized section 987 gain or loss of a section 987 QBU (temporary).

(a) through (c)(1) [Reserved]. For further guidance, see § 1.987–4(a) through (c)(1).

(2) *Coordination with § 1.987–12T*. For purposes of paragraph (c)(1) of this section, amounts taken into account under § 1.987–5 are determined without regard to § 1.987–12T.

(d) through (e) [Reserved]. For further guidance, see § 1.987–4(d) through (e).

(f) *Combinations and separations*—(1) *Combinations*. The net unrecognized section 987 gain or loss of a combined QBU (as defined in § 1.987–2T(c)(9)(i)) for a taxable year is determined under § 1.987–4(b) by taking into account the net accumulated unrecognized section 987 gain or loss of each combining QBU (as defined in § 1.987–2T(c)(9)(i)) for all prior taxable years to which the regulations under section 987 apply, as determined under § 1.987–4(c), and by treating the combining QBUs as having combined immediately prior to the beginning of the taxable year of combination.

(2) *Separations*. The net unrecognized section 987 gain or loss of a separated QBU (as defined in § 1.987–2T(c)(9)(iii)) for a taxable year is determined under § 1.987–4(b) by taking into account the separated QBU's share of the net accumulated unrecognized section 987 gain or loss of the separating QBU (as defined in § 1.987–2T(c)(9)(iii)) for all prior taxable years to which the regulations under section 987 apply, as determined under § 1.987–4(c), and by treating the separating QBU as having separated immediately prior to the beginning of the taxable year of separation. A separated QBU's share of the separating QBU's net accumulated unrecognized section 987 gain or loss for all such prior taxable years is determined by apportioning the separating QBU's net accumulated unrecognized section 987 gain or loss for all such prior taxable years to each separated QBU in proportion to the aggregate adjusted basis of the gross assets properly reflected on the books and records of each separated QBU immediately after the separation. For purposes of determining the owner functional currency net value of the separated QBUs on the last day of the taxable year preceding the taxable year of separation under § 1.987–5(d)(1)(B) and (e), the balance sheets of the separated QBUs on that day will be deemed to reflect the assets and liabilities reflected on the balance sheet of the separating QBU on that day, apportioned between the separated QBUs in a reasonable manner that takes into account the assets and liabilities reflected on the balance sheets of the separated QBUs immediately after the separation.

(3) *Examples*. The following examples illustrate the rules of paragraphs (f)(1) and (2) of this section.

Example 1. Combination of two section 987 QBUs that have the same owner. (i) *Facts*. DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in France that constitutes a section 987 QBU (French QBU) that has the euro as its functional currency. French QBU has a net accumulated unrecognized section 987 loss from all prior taxable years to which the regulations under section 987 apply of $100. DC1 also owns Entity B, a DE. Entity B conducts a business in Germany that constitutes a section 987 QBU (German QBU) that has the euro as its functional currency. German QBU has a net accumulated unrecognized section 987 gain from all prior taxable years to which the regulations under section 987 apply of $110. During the taxable year, Entity A and Entity B merge under local law. As a result, the books and records of French QBU and German QBU are combined into a new single set of books and records. The combined entity has the euro as its functional currency.

(ii) *Analysis*. Pursuant to § 1.987–2T(c)(9)(i), French QBU and German QBU are combining QBUs, and their combination does not give rise to a transfer that is taken into account in determining the amount of a remittance (as defined in § 1.987–5(c)). For purposes of computing net unrecognized section 987 gain or loss under § 1.987–4 for the year of the combination, the combination is deemed to have occurred on the last day of the owner's prior taxable year, such that the owner functional currency net value of the combined section 987 QBU at the end of that taxable year described under § 1.987–4(d)(1)(B) takes into account items reflected on the balance sheets of both French QBU and German QBU at that time. Additionally, any transactions between French QBU and German QBU occurring during the year of the merger will not result in transfers to or from a section 987 QBU. Pursuant to paragraph (f)(1) of this section, the combined QBU will have a net accumulated unrecognized section 987 gain from all prior taxable years of $10 (the $100 loss from French QBU plus the $110 gain from German QBU).

Example 2. Separation of two section 987 QBUs that have the same owner. (i) *Facts*. DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in the Netherlands that constitutes a section 987 QBU (Dutch QBU) that has the euro as its functional currency. The business of Dutch QBU consists of manufacturing and selling bicycles and scooters and is recorded on a single set of books and records. On the last day of Year 1, the adjusted basis of the gross assets of Dutch QBU is €1,000. In Year 2, the net accumulated unrecognized section 987 loss of Dutch QBU from all prior taxable years is $200. During Year 2, Entity A separates the bicycle and scooter business such that each business begins to have its own books and records and to meet the definition of a section 987 QBU under § 1.987–1(b)(2) (hereafter, "bicycle QBU" and "scooter QBU"). There are no transfers between DC1 and Dutch QBU before the separation. After the separation, the aggregate adjusted basis of bicycle QBU's assets is €600 and the aggregate adjusted basis of scooter QBU's assets is €400. Each section 987 QBU continues to have the euro as its functional currency.

(ii) *Analysis*. Pursuant to § 1.987–2T(c)(9)(iii), bicycle QBU and scooter QBU are separated QBUs, and the separation of Dutch QBU, a separating QBU, does not give rise to a transfer taken into account in determining the amount of a remittance (as defined in § 1.987–5(c)). For purposes of computing net unrecognized section 987 gain or loss under § 1.987–4 for Year 2, the separation will be deemed to have occurred on the last day of the owner's prior taxable year, Year 1. Pursuant to paragraph (f)(2) of this section, bicycle QBU will have a net accumulated unrecognized section 987 loss of $120 (€600/€1,000 x $200), and scooter QBU will have a net accumulated unrecognized section 987 loss of $80 (€400/€1,000 x $200).

(g) [Reserved]. For further guidance, see § 1.987–4(g).

(h) *Effective/applicability date*. This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(i) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 11. Section 1.987–6 is amended by adding paragraph (b)(4) to read as follows:

§ 1.987–6 Character and source of section 987 gain or loss.

* * * * *

(b) * * *

(4) [Reserved]. For further guidance, see § 1.987–6T(b)(4).

* * * * *

Par. 12. Section 1.987–6T is added to read as follows:

§ 1.987–6T Character and source of section 987 gain or loss (temporary)

(a) through (b)(3) [Reserved]. For further guidance, see § 1.987–6(a) through (b)(3).

(4) *Source of section 987 gain or loss with respect to a dollar QBU*. The source of section 987 gain or loss with respect to a dollar QBU (as defined in § 1.987–

1T(b)(6)(i)) for which the CFC owner has elected under § 1.987–1T(b)(6)(iii) to apply section 987 is determined by reference to the residence of the CFC owner. This paragraph (b)(4) applies to any CFC that has made the election under § 1.987–1T(b)(6)(iii), including a CFC described in § 1.987–1(b)(1)(ii).

(c) [Reserved]. For further guidance, see § 1.987–6(c).

(d) *Effective/applicability date*. This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(e) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 13. Section 1.987–7 is amended by adding paragraph (b) to read as follows:

§ 1.987–7 Section 987 aggregate partnerships.

* * * * *

(b) [Reserved]. For further guidance, see § 1.987–7T(b).

* * * * *

Par. 14. Section 1.987–7T is added to read as follows:

§ 1.987–7T Section 987 aggregate partnerships (temporary).

(a) [Reserved]. For further guidance, see § 1.987–7(a).

(b) *Liquidation value percentage methodology*—(1) *In general*. In any taxable year, a partner's share of each asset, including its basis in each asset, and the amount of each liability reflected under § 1.987–2(b) on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership is proportional to the partner's liquidation value percentage with respect to the aggregate partnership for that taxable year, as determined under paragraph (b)(2) of this section.

(2) *Liquidation value percentage*—(i) *In general*. For purposes of this paragraph (b), a partner's liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all of the partners' interests in the partnership. The liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752–7), paid an unrelated third party to assume all of its § 1.752–7 liabilities in a fully taxable transaction, and then liquidated.

(ii) *Determination date*.—(A) *In general*. Except as provided in paragraph (b)(2)(ii)(B) of this section, the determination date is the date of the most recent event described in § 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (a revaluation event), irrespective of whether the capital accounts of the partners are adjusted under § 1.704–1(b)(2)(iv)(*f*), or, if there has been no revaluation event, the date of the formation of the partnership.

(B) *Allocations not in accordance with liquidation value percentage*. If a partnership agreement provides for the allocation of any item of income, gain, deduction, or loss from partnership property to a partner other than in accordance with the partner's liquidation value percentage, the determination date is the last day of the partner's taxable year, or, if the partner's section 987 QBU owned indirectly through a section 987 aggregate partnership terminates during the partner's taxable year, the date such section 987 QBU is terminated.

(3) *Example*. The following example illustrates the rule of this paragraph (b).

Example. (i) *Facts*. DC, a domestic corporation, owns all of the stock of FS, a controlled foreign corporation (as defined in section 957(a)) with the U.S. dollar as its functional currency. FS owns a capital and profits interest in FPRS, a foreign partnership. The remaining capital and profits interest in FPRS is owned by DC. FPRS is a section 987 aggregate partnership with the euro as its functional currency. The balance sheet of FPRS reflects one asset (Asset A) with a basis of €60x and a fair market value of €100x, another asset (Asset B) with a basis of €100x and a fair market value of €200x, and a liability (Liability) of €50x. At the end of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, of DC with respect to FPRS is 75 percent, and the liquidation value percentage of FS with respect to FPRS is 25 percent.

(ii) *Result*. Under § 1.987–1(b)(4), DC and FS are each treated as indirectly owning an eligible QBU with a balance sheet that reflects their respective shares of any assets and liabilities of FPRS. Under paragraph (b)(1) of this section, DC and FS's shares of FPRS's assets and liabilities are determined in accordance with DC and FS's respective liquidation value percentages. Accordingly, because DC has a liquidation value percentage of 75 percent with respect to FPRS, €75x of Asset A (with a €45x basis), €150x of Asset B (with a €75x basis), and €37.50x of Liability will be attributed to the DC-FPRS QBU. Additionally, because FS has a liquidation value percentage of 25 percent with respect to FPRS, €25x of Asset A (with a €15x basis), €50x of Asset B (with a €25x basis), and €12.50x of Liability will be attributed to the FS-FPRS QBU.

(c) [Reserved]. For further guidance, see § 1.987–7(c).

(d) *Effective/applicability date*. This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(e) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 15. Section 1.987–8 is amended by adding paragraph (d) to read as follows:

§ 1.987–8 Termination of a section 987 QBU.

* * * * *

(d) [Reserved]. For further guidance, see § 1.987–8T(d).

* * * * *

Par. 16. Section 1.987–8T is added to read as follows

§ 1.987–8T Termination of a section 987 QBU (temporary).

(a) through (c) [Reserved]. For further guidance, see § 1.987–8(a) through (c).

(d) *Annual deemed termination election*. A taxpayer, including a taxpayer described in § 1.987–1(b)(1)(ii) to which §§ 1.987–1 through 1.987–11 generally do not apply, may elect under this paragraph (d) to deem all of the section 987 QBUs of which it is an owner to terminate on the last day of each taxable year for which the election is in effect. See § 1.987–8(e) regarding the effect of such a deemed termination. The owner of a section 987 QBU that is deemed to terminate under this paragraph is treated as having transferred all of the assets and liabilities attributable to such section 987 QBU to a new section 987 QBU on the first day of the following taxable year.

(e) through (f) [Reserved]. For further guidance, see § 1.987–8(e) through (f).

(g) *Effective/applicability date*. This section applies to taxable years beginning on or after December 7, 2016.

(h) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 17. Section 1.987–12 is added to read as follows:

§ 1.987–12 Deferral of section 987 gain or loss.

(a) through (h) [Reserved]. For further guidance, see § 1.987–12T(a) through (h).

Par. 18. Section 1.987–12T is added to read as follows:

§ 1.987–12T Deferral of section 987 gain or loss (temporary).

(a) *In general*—(1) *Overview*. This section provides rules that defer the recognition of section 987 gain or loss that, but for this section, would be recognized in connection with certain QBU terminations and certain other transactions involving partnerships. This paragraph (a) provides an overview of this section and describes the section's scope of application, including with respect to QBUs subject to section 987 but to which §§ 1.987–1 through 1.987–11 generally do not apply. Paragraph (b) of this section describes the extent to which section 987 gain or loss is recognized under § 1.987–5 or similar principles in the taxable year of a deferral event (as defined in paragraph (b)(2) of this section) with respect to a QBU. Paragraph (c) of this section describes the extent to which section 987 gain or loss that, as a result of paragraph (b), is not recognized under § 1.987–5 or similar principles is recognized upon the occurrence of subsequent events. Paragraph (d) of this section describes the extent to which section 987 loss is recognized under § 1.987–5 or similar principles in the taxable year of an outbound loss event (as defined in paragraph (d)(2) of this section) with respect to a QBU. Paragraph (e) of this section provides rules for determining the source and character of gains and losses that, as a result of this section, are not recognized under § 1.987–5 or similar principles in the taxable year of a deferral event or outbound loss event. Paragraph (f) of this section defines controlled group and qualified successor for purposes of this section. Paragraph (g) of this section provides an anti-abuse rule. Paragraph (h) of this section provides examples illustrating the rules described in this section.

(2) *Scope*. This section applies to any foreign currency gain or loss realized under section 987(3), including foreign currency gain or loss of an entity described in § 1.987–1(b)(1)(ii). References in this section to section 987 gain or loss refer to any foreign currency gain or loss realized under section 987(3), references to a section 987 QBU refer to any eligible QBU (as defined in § 1.987–1(b)(3)(i), but without regard to § 1.987–1(b)(3)(ii)) that is subject to section 987, and references to a section 987 aggregate partnership refer to any partnership for which the acquisition or disposition of a partnership interest could give rise to foreign currency gain or loss realized under section 987(3). Additionally, references to recognition of section 987 gain or loss under § 1.987–5 encompass any determination and recognition of gain or loss under section 987(3) that would occur but for this section. Accordingly, the principles of this section apply to a QBU subject to section 987 regardless of whether the QBU otherwise is subject to §§ 1.987–1 through 1.987–11. An owner of a QBU that is not subject to § 1.987–5 must adapt the rules set forth in this section as necessary to recognize section 987 gains or losses that are subject to this section consistent with the principles of this section.

(3) *Exceptions*—(i) *Annual deemed termination elections*. This section does not apply to section 987 gain or loss of a section 987 QBU with respect to which the annual deemed termination election described in § 1.987–8T(d) is in effect.

(ii) *De minimis exception*. This section does not apply to a section 987 QBU for a taxable year if the net unrecognized section 987 gain or loss of the section 987 QBU that, as a result of this section, would not be recognized under § 1.987–5 in the taxable year does not exceed $5 million.

(b) *Gain and loss recognition in connection with a deferral event*—(1) *In general*. Notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which a deferral event occurs (a deferral QBU) includes in taxable income section 987 gain or loss in connection with the deferral event only to the extent provided in paragraphs (b)(3) and (c) of this section. However, if the deferral event also constitutes an outbound loss event described in paragraph (d) of this section, the amount of loss recognized by the owner may be further limited under that paragraph.

(2) *Deferral event*—(i) *In general*. A deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy the conditions described in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section.

(ii) *Transactions*. The transaction or series of transactions include either:

(A) A termination of the section 987 QBU other than any of the following terminations: a termination described in § 1.987–8(b)(3), a termination described in § 1.987–8(c), or a termination described solely in § 1.987–8(b)(1); or

(B) A disposition of part of an interest in a section 987 aggregate partnership or DE through which the section 987 QBU is owned or any contribution by another person to such a partnership or DE of assets that, immediately after the contribution, are not considered to be included on the books and records of an eligible QBU, provided that the contribution gives rise to a deemed transfer from the section 987 QBU to the owner.

(iii) *Assets on books of successor QBU*. Immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor QBU (as defined in paragraph (b)(4) of this section).

(3) *Gain or loss recognized under § 1.987–5 in the taxable year of a deferral event*. In the taxable year of a deferral

event with respect to a deferral QBU, the owner of the deferral QBU recognizes section 987 gain or loss as determined under § 1.987–5, except that, solely for purposes of applying § 1.987–5, all assets and liabilities of the deferral QBU that, immediately after the deferral event, are reflected on the books and records of a successor QBU are treated as not having been transferred and therefore as remaining on the books and records of the deferral QBU notwithstanding the deferral event.

(4) *Successor QBU*. For purposes of this section, a section 987 QBU (potential successor QBU) is a successor QBU with respect to a section 987 QBU referred to in paragraph (b)(2)(ii) of this section if, immediately after the transaction or series of transactions described in that paragraph, the potential successor QBU satisfies all of the conditions described in paragraphs (b)(4)(i) through (b)(4)(iii) of this section.

(i) The books and records of the potential successor QBU reflect assets that, immediately before the transaction or series of transactions described in paragraph (b)(2)(ii) of this section, were reflected on the books and records of the section 987 QBU referred to in that paragraph.

(ii) The owner of the potential successor QBU and the owner of the section 987 QBU referred to in paragraph (b)(2)(ii) of this section immediately before the transaction or series of transactions described in that paragraph are members of the same controlled group.

(iii) In the case of a section 987 QBU referred to in paragraph (b)(2)(ii)(A) of this section, if the owner of the section 987 QBU immediately before the transaction or series of transactions described in that paragraph was a U.S. person, the potential successor QBU is owned by a U.S. person.

(c) *Recognition of deferred section 987 gain or loss in the taxable year of a deferral event and in subsequent taxable years*—(1) *In general*—(i) *Deferred section 987 gain or loss*. A deferral QBU owner (as defined in paragraph (c)(1)(ii) of this section) recognizes section 987 gain or loss attributable to the deferral QBU that, as a result of paragraph (b) of this section, is not recognized in the taxable year of the deferral event under § 1.987–5 (deferred section 987 gain or loss) in the taxable year of the deferral event and in subsequent taxable years as provided in paragraphs (c)(2) through (4) of this section.

(ii) *Deferral QBU owner*. For purposes of this paragraph (c), a deferral QBU owner means, with respect to a deferral QBU, the owner of the deferral QBU immediately before the deferral event, or the owner's qualified successor.

(2) *Recognition upon a subsequent remittance*—(i) *In general*. Except as provided in paragraph (c)(3) of this section, a deferral QBU owner recognizes deferred section 987 gain or loss in the taxable year of the deferral event and in subsequent taxable years upon a remittance from a successor QBU to the owner of the successor QBU (successor QBU owner) in the amount described in paragraph (c)(2)(ii) of this section.

(ii) *Amount*. The amount of deferred section 987 gain or loss that is recognized pursuant to this paragraph (c)(2) in a taxable year of the deferral QBU owner is the outstanding deferred section 987 gain or loss (that is, the amount of deferred section 987 gain or loss not previously recognized) multiplied by the remittance proportion of the successor QBU owner with respect to the successor QBU for the taxable year ending with or within the taxable year of the deferral QBU owner, as determined under § 1.987–5(b) (and, to the extent relevant, paragraphs (b) and (c)(2)(iii) of this section) without regard to any election under § 1.987–8T(d). For purposes of computing this remittance proportion, multiple successor QBUs of the same deferral QBU are treated as a single successor QBU.

(iii) *Deemed remittance when a successor QBU ceases to be owned by a member of the deferral QBU owner's controlled group*. For purposes of this paragraph (c)(2), in a taxable year of the deferral QBU owner in which a successor QBU ceases to be owned by a member of a controlled group that includes the deferral QBU owner, the successor QBU owner is treated as having a remittance proportion of 1. Accordingly, if there is only one successor QBU with respect to a deferral QBU and that successor QBU ceases to be owned by a member of the controlled group that includes the deferral QBU owner, all outstanding deferred section 987 gain or loss with respect to that deferral QBU will be recognized. This paragraph (c)(2)(iii) does not affect the application of §§ 1.987–1 through 1.987–11 to the successor QBU owner with respect to its ownership of the successor QBU.

(3) *Recognition of deferred section 987 loss in certain outbound successor QBU terminations*. Notwithstanding paragraph (c)(2) of this section, if assets of the successor QBU (transferred assets) are transferred (or deemed transferred) in a transaction that would constitute an outbound loss event if the successor QBU had a net accumulated section 987 loss at the time of the exchange, then the deferral QBU owner recognizes outstanding deferred section 987 loss, if any, to the extent it would recognize loss under paragraph (d)(1) of this section if (i) the deferral QBU owner owned the successor QBU, (ii) the deferral QBU owner had net unrecognized section 987 loss with respect to the successor QBU equal to its outstanding deferred section 987 loss with respect to the deferral QBU, and (iii) the transferred assets were transferred (or deemed transferred) in an outbound loss event. Any outstanding deferred section 987 loss with respect to the deferral QBU that is not recognized as a result of the preceding sentence is recognized by the deferral QBU owner in the first taxable year in which the deferral QBU owner (including any qualified successor) ceases to be a member of a controlled group that includes the acquirer of the transferred assets or any qualified successor of such acquirer.

(4) *Special rules regarding successor QBUs*—(i) *Successor QBU with respect to a deferral QBU that is a successor QBU*. If a section 987 QBU is a successor QBU with respect to a deferral QBU that is a successor QBU with respect to another deferral QBU, the first-mentioned section 987 QBU is considered a successor QBU with respect to the second-mentioned deferral QBU. For example, if QBU A is a successor QBU with respect to QBU B, and QBU B is a successor QBU with respect to QBU C, then QBU A is a successor QBU with respect to QBU C.

(ii) *Separation of a successor QBU*. If a successor QBU with respect to a deferral QBU separates into two or more separated

QBUs (as defined in § 1.987–2T(c)(9)(iii)), each separated QBU is considered a successor QBU with respect to the deferral QBU.

(iii) *Combination of a successor QBU*. If a successor QBU with respect to a deferral QBU combines with another section 987 QBU of the same owner, resulting in a combined QBU (as defined in § 1.987–2T(c)(9)(i)), the combined QBU is considered a successor QBU with respect to the deferral QBU.

(d) *Loss recognition upon an outbound loss event*—(1) *In general*. Notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which an outbound loss event occurs (an outbound loss QBU) includes in taxable income in the taxable year of an outbound loss event section 987 loss with respect to that section 987 QBU only to the extent provided in paragraph (d)(3) of this section.

(2) *Outbound loss event*. An outbound loss event means, with respect to a section 987 QBU:

(i) Any termination of the section 987 QBU in connection with a transfer by a U.S. person of assets of the section 987 QBU to a foreign person that is a member of the same controlled group as the U.S. transferor immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (related foreign person), provided that the termination would result in the recognition of section 987 loss with respect to the section 987 QBU under § 1.987–5 and paragraph (b) of this section but for this paragraph (d);

(ii) Any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership or DE through which the U.S. person owns the section 987 QBU to a related foreign person that has the same functional currency as the section 987 QBU, or any contribution by such a related foreign person to such a partnership or DE of assets that, immediately after the contribution, are not considered to be included on the books and records of an eligible QBU, provided that the transfer would result in the recognition of section 987 loss with respect to the section 987 QBU under § 1.987–5 and paragraph (b) of this section but for this paragraph (d).

(3) *Loss recognized upon an outbound loss event*. In the taxable year of an outbound loss event with respect to an outbound loss QBU, the owner of the outbound loss QBU recognizes section 987 loss as determined under § 1.987–5 and paragraphs (b) and (c) of this section, except that, solely for purposes of applying § 1.987–5, the following assets and liabilities of the outbound loss QBU are treated as not having been transferred and therefore as remaining on the books and records of the outbound loss QBU notwithstanding the outbound loss event:

(i) In the case of an outbound loss event described in paragraph (d)(2)(i) of this section, assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the related foreign person described in that paragraph or of a section 987 QBU owned by such related foreign person; and

(ii) In the case of an outbound loss event described in paragraph (d)(2)(ii) of this section, assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the eligible QBU from which the assets and liabilities of the outbound loss QBU are allocated and not on the books and records of a section 987 QBU.

(4) *Adjustment of basis of stock received in certain nonrecognition transactions*. If an outbound loss event results from the transfer of assets of the outbound loss QBU in a transaction described in section 351 or section 361, the basis of the stock that is received in the transaction is increased by an amount equal to the section 987 loss that, as a result of this paragraph (d), is not recognized with respect to the outbound loss QBU in the taxable year of the outbound loss event (outbound section 987 loss).

(5) *Recognition of outbound section 987 loss that is not converted into stock basis*. Outbound section 987 loss attributable to an outbound loss event that is not described in paragraph (d)(4) of this section is recognized by the owner of the outbound loss QBU in the first taxable year in which the owner or any qualified successor of the owner ceases to be a member of a controlled group that includes the related foreign person referred to in paragraph (d)(2)(i) or (ii) of this section, or any qualified successor of such person.

(e) *Source and character*—(1) *Deferred section 987 gain or loss and certain outbound section 987 loss*. The source and character of deferred section 987 gain or loss recognized pursuant to paragraph (c) of this section, and of outbound section 987 loss recognized pursuant to paragraph (d)(5) of this section, is determined under § 1.987–6 as if such deferred section 987 gain or loss were recognized pursuant to § 1.987–5 without regard to this section on the date of the related deferral event or outbound loss event.

(2) *Outbound section 987 loss reflected in stock basis*. If loss is recognized on the sale or exchange of stock described in paragraph (d)(4) of this section within two years of the outbound loss event described in that paragraph, then, to the extent of the outbound section 987 loss, the source and character of the loss recognized on the sale or exchange is determined under § 1.987–6 as if such loss were section 987 loss recognized pursuant to § 1.987–5 without regard to this section on the date of the outbound loss event.

(f) *Definitions*—(1) *Controlled group*. For purposes of this section, a controlled group means all persons with the relationships to each other specified in sections 267(b) or 707(b).

(2) *Qualified successor*. For purposes of this section, a qualified successor with respect to a corporation (transferor corporation) means another corporation (acquiring corporation) that acquires the assets of the transferor corporation in a transaction described in section 381(a), but only if (A) the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or (B) the acquiring corporation is a controlled foreign corporation (as defined in section 957(a)) (CFC) and the transferor corporation was a CFC. A qualified successor of a corporation includes the qualified successor of a qualified successor of the corporation.

(g) *Anti-abuse*. No section 987 loss is recognized under § 1.987–5 or this section in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(h) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the stock of DC2, which is also a domestic corporation, and CFC1 and CFC2 are CFCs. In addition, DC1, DC2, CFC1, and CFC2 are members of a controlled group as defined in paragraph (f)(1) of this section, and the de minimis rule of paragraph (a)(3)(ii) of this section is not applicable. Finally, except as otherwise provided, Business A is a section 987 QBU with the euro as its functional currency, there are no transfers between Business A and its owner, and Business A's assets are not depreciable or amortizable.

Example 1. Contribution of a section 987 QBU to a member of the controlled group. (i) *Facts*. DC1 owns all of the interests in Business A. The balance sheet of Business A reflects assets with an aggregate adjusted basis of €1,000x and no liabilities. DC1 contributes €900x of Business A's assets to DC2 in an exchange to which section 351 applies. Immediately after the contribution, the remaining €100x of Business A's assets are no longer reflected on the books and records of a section 987 QBU. DC2, which has the U.S. dollar as its functional currency, uses the former Business A assets in a business (Business B) that constitutes a section 987 QBU. At the time of the contribution, Business A has net accumulated unrecognized section 987 gain of $100x.

(ii) *Analysis*. (A) Under § 1.987–2(c)(2)(ii), DC1's contribution of €900x of Business A's assets to DC2 is treated as a transfer of all of the assets of Business A to DC1, immediately followed by DC1's contribution of €900x of Business A's assets to DC2. The contribution of Business A's assets is a deferral event within the meaning of paragraph (b)(2) of this section because: (1) the transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, resulting in a termination of Business A under § 1.987–8(b)(2); and (2) immediately after the transaction, assets of Business A are reflected on the books and records of Business B, a section 987 QBU owned by a member of DC1's controlled group and a successor QBU within the meaning of paragraph (b)(4) of this section. Accordingly, Business A is a deferral QBU within the meaning of paragraph (b)(1) of this section, and DC1 is a deferral QBU owner of Business A within the meaning of paragraph (c)(1)(ii) of this section.

(B) Under paragraph (b)(3) of this section, DC1's taxable income in the taxable year of the deferral event includes DC1's section 987 gain or loss determined with respect to Business A under § 1.987–5, except that, for purposes of applying § 1.987–5, all assets and liabilities of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under § 1.987–8(e)). Accordingly, in the taxable year of the deferral event, DC1 is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books at the end of the year. Thus, DC1 recognizes $10x of section 987 gain in the taxable year of the deferral event. DC1's deferred section 987 gain equals $90x, which is the amount of section 987 gain that, but for the application of paragraph (b) of this section, DC1 would have recognized under § 1.987–5 ($100x), less the amount of section 987 gain recognized by DC1 under § 1.987–5 and this section ($10x).

Example 2. Election to be classified as a corporation. (i) *Facts*. DC1 owns all of the interests in Entity A, a DE. Entity A conducts Business A, which has net accumulated unrecognized section 987 gain of $500x. Entity A elects to be classified as a corporation under § 301.7701–3(a). As a result of the election and pursuant to § 301.7701–3(g)(1)(iv), DC1 is treated as contributing all of the assets and liabilities of Business A to newly-formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's balance sheet.

(ii) *Analysis*. Under § 1.987–2(c)(2)(ii), DC1's contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A QBU terminates under § 1.987–8(b)(2). The contribution of Business A's assets is not a deferral event within the meaning of paragraph (b)(2) of this section because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor QBU within the meaning of paragraph (b)(4) of this section due to the fact that the assets of Business A are not reflected on a section 987 QBU immediately after the termination as well as the fact that the requirement of paragraph (b)(4)(iii) of this section is not met. Accordingly, DC1 recognizes section 987 gain with respect to Business A under § 1.987–5 without regard to this section. Because the requirement of paragraph (b)(4)(iii) of this section is not met, the result would be the same even if the assets of Business A were transferred in a section 351 exchange to an existing foreign corporation that had a different functional currency than Business A.

Example 3. Outbound loss event. (i) *Facts*. The facts are the same as in *Example 2*, except that Business A has net accumulated unrecognized section 987 loss of $500x rather than net accumulated unrecognized section 987 gain of $500x.

(ii) *Analysis*. (A) The analysis of the transactions under §§ 1.987–2(c)(2)(ii), 1.987–8(b)(2), and paragraph (b) of this section is the same as in *Example 2*. However, the termination of Business A as a result of the transfer of the assets of Business A by a U.S. person (DC1) to a foreign person (CFC1) that is a member of DC1's controlled group is an outbound loss event described in paragraph (d)(2) of this section.

(B) Under paragraphs (d)(1) and (d)(3) of this section, in the taxable year of the outbound loss event, DC1 includes in taxable income section 987 loss recognized with respect to Business A as determined under § 1.987–5, except that, for purposes of applying § 1.987–5, all assets and liabilities of Business A that are reflected on the books and records of CFC1, a related foreign person described in paragraph (d)(2) of this section, are treated as not having been transferred. Accordingly, DC1's remittance proportion with respect to Business A is 0, and DC1 recognizes no section 987 loss with respect to Business A. DC1's outbound section 987 loss is $500x, which is the amount of section 987 loss that DC1 would have recognized under § 1.987–5 ($500x) without regard to paragraph (d) of this section, less the amount of section 987 loss recognized by DC1 under paragraph (d)(3) of this section ($0). Under paragraph (d)(4) of this section, DC1 must increase its basis in its CFC1 shares by the amount of the outbound section 987 loss ($500x).

Example 4. Conversion of a DE to a partnership. (i) *Facts*. DC1 owns all of the interests in Entity A, a DE that conducts Business A. On the last day of Year 1, DC1 sells 50 percent of its interest in Entity A to DC2 (the Entity A sale).

(ii) *Analysis*. (A) For Federal income tax purposes, Entity A is converted to a partnership when DC2 purchases the 50 percent interest in Entity A. DC2's purchase is treated as the purchase of 50 percent of the assets of Entity A (that is, the assets of Business A), which, prior to the purchase, were treated as held directly by DC1 for Federal income tax purposes. Immediately after DC2's deemed purchase of 50 percent of Business A assets, DC1 and DC2 are treated as contributing their respective interests in Business A assets to a partnership. See Rev. Rul. 99–5 (1999–1 CB 434) (situation 1). These deemed transactions are not taken into account for purposes of this section, but the Entity A sale and resulting existence of a partnership have consequences under section 987 and this section, as described in paragraphs (ii)(B) through (D) of this *Example 4*.

(B) Immediately after the Entity A sale, Entity A is a section 987 aggregate partnership within the meaning of § 1.987–1(b)(5) because DC1 and DC2 own all the interests in partnership capital and profits, DC1 and DC2 are related within the meaning of section 267(b), and the partnership has an eligible QBU (Business A) that would be a section 987 QBU with respect to a partner if owned by the partner directly. As a result of the Entity A sale, 50 percent of the assets and liabilities of Business A ceased to be reflected on the books and records of DC1's Business A section 987 QBU. As a result, such assets and liabilities are treated as if they were transferred from DC1's Business A section 987 QBU to DC1. Additionally, following DC2's acquisition of 50 percent of the interest in Entity A, DC2 is allocated 50 percent of the assets and liabilities of Business A under §§ 1.987–2(b), 1.987–7(a), and 1.987–7T(b). Because DC2 and Business A have different functional currencies, DC2's portion of the Business A assets and liabilities constitutes a section 987 QBU. Accordingly, 50 percent of the assets and liabilities of Business A are treated as transferred by DC2 to DC2's Business A section 987 QBU.

(C) The Entity A sale is a deferral event described in paragraph (b)(2) of this section because: (1) the sale constitutes the disposition of part of an interest in a DE; and (2) immediately after the transaction, assets of DC1's Business A section 987 QBU are reflected on the books and records of DC1's Business A section 987 QBU and DC2's Business A section 987 QBU, each of which is a successor QBU with respect to DC1's Business A section 987 QBU within the meaning of paragraph (b)(4) of this section. Accordingly, DC1's Business A section 987 QBU is a deferral QBU within the meaning of paragraph (b)(1) of this section, and DC1 is a deferral QBU owner within the meaning of paragraph (c)(1)(ii) of this section. Under paragraph (b)(1) of this section, DC1 includes in taxable income section 987 gain or loss with respect to Business A in connection with the deferral event to the extent provided in paragraphs (b)(3) and (c) of this section.

(D) Under paragraph (b) of this section, in the taxable year of the Entity A sale, DC1 includes in taxable income section 987 gain or loss with respect to Business A as determined under § 1.987–5, except that, for purposes of applying § 1.987–5, all assets and liabilities of Business A that, immediately after the Entity A sale, are reflected on the books and records of successor QBUs are treated as though they were not transferred and therefore as remaining on the books and records of DC1's Business A section 987 QBU notwithstanding the Entity A sale. Accordingly, DC1's remittance amount under § 1.987–5 is $0, and DC1 recognizes no section 987 gain or loss with respect to Business A.

Example 5. Partial recognition of deferred gain or loss. (i) *Facts*. DC1 owns all of the interests in Entity A, a DE that conducts Business A in Country X. During Year 1, DC1 contributes all of its interests in Entity A to DC2 in an exchange to which section 351 applies. At the time of the contribution, Business A has net accumulated unrecognized section 987 gain of $100x. After the contribution, Entity A continues to conduct business in Country X (Business B). In Year 3, as a result of a net transfer of property from Business B to DC2, DC2's remittance proportion with respect to Business B, as determined under § 1.987–5, is 0.25.

(ii) *Analysis*. (A) For the reasons described in *Example 1*, the contribution of Entity A by DC1 to DC2 results in a termination of Business A and a deferral event with respect to Business A, a deferral QBU; DC1 is a deferral QBU owner within the meaning of paragraph (c)(1)(ii) of this section; Business B is a successor QBU with respect to Business A; DC2 is a successor QBU owner; and the $100x of net accumulated unrecognized section 987 gain with respect to Business A becomes deferred section 987 gain as a result of the deferral event.

(B) Under paragraph (c)(1) of this section, DC1 recognizes deferred section 987 gain with respect to Business A in accordance with paragraphs (c)(2) through (4) of this section. Under paragraph (c)(2)(i) of this section, DC1 recognizes deferred section 987 gain in Year 3 as a result of the remittance from Business B to DC2. Under paragraph (c)(2)(ii) of this section, the amount of deferred section 987 gain that DC1 recognizes is $25x, which is DC1's outstanding deferred section 987 gain or loss ($100x) with respect to Business A multiplied by the remittance proportion (0.25) of DC2 with respect to Business B for the taxable year as determined under § 1.987–5(b).

(i) *Coordination with fresh start transition method*—(1) *In general*. If a taxpayer is a deferral QBU owner, or is or was the owner of an outbound loss QBU, and the taxpayer is required under § 1.987–10(a) to apply the fresh start transition method described in § 1.987–10(b) to the deferral QBU or outbound loss QBU, or would have been so required if the taxpayer had owned the deferral QBU or outbound loss QBU on the transition date (as defined in § 1.987–11(c)), the adjustments described in paragraphs (i)(2) and (i)(3) of this section, as applicable, must be made on the transition date.

(2) *Adjustment to deferred section 987 gain or loss*. The amount of any outstanding deferred section 987 gain or loss of a deferral QBU owner with respect to a deferral QBU described in paragraph (i)(1) of this section must be adjusted to equal the amount of outstanding deferred section 987 gain or loss that the deferral QBU owner would have had with respect to the deferral QBU on the transition date if, immediately before the deferral event, the deferral QBU had transitioned to the method prescribed by §§ 1.987–1 through 1.987–10 pursuant to the fresh start transition method.

(3) *Adjustments in the case of an outbound loss event*. The basis of any stock described in paragraph (d)(4) of this section that was received in connection with the transfer (or deemed transfer) of assets of an outbound loss QBU described in paragraph (i)(1) of this section and that is held on the transition date must be adjusted to equal the basis that such stock would have had on the transition date if, immediately prior to the outbound loss event, the outbound loss QBU had transitioned to the method prescribed by §§ 1.987–1 through 1.987–10 pursuant to the fresh start transition method. If no such stock was received, the amount of any outbound section 987 loss with respect to the outbound loss QBU that may be recognized on or after the transition date pursuant to paragraph (d)(5) of this section must be adjusted to equal the amount of such loss that would be outstanding and that may be recognized pursuant to that paragraph if, immediately before the outbound loss event, the outbound loss QBU had transitioned to the method prescribed by §§ 1.987–1 through 1.987–10 pursuant to the fresh start transition method.

(j) *Effective/applicability date*—(1) *In general*. Except as described in paragraph (j)(2) of this section, this section applies to any deferral event or outbound loss event that occurs on or after January 6, 2017.

(2) *Exception*. This section applies to any deferral event or outbound loss event that occurs on or after December 7, 2016, if such deferral event or outbound loss event is undertaken with a principal purpose of recognizing section 987 loss.

(k) *Expiration date*. The applicability of this section expires December 6, 2019.

Par. 19. Section 1.988–0 is amended by revising the entry for § 1.988–2(b)(16) and adding an entry for § 1.988–2(i) to read as follows:

§ 1.988–0. Taxation of gain or loss from a section 988 transaction; Table of contents.

* * * * *

§ 1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(16) [Reserved].

* * * * *

(i) [Reserved].

Par. 20. Section 1.988–1 is amended by adding paragraph (a)(3) to read as follows:

§ 1.988–1 Certain definitions and special rules.

* * * * *

(a) * * *

(3) [Reserved]. For further guidance, see § 1.988–1T(a)(3).

* * * * *

Par. 21. Section 1.988–1T is added to read as follows:

§ 1.988–1T Certain definitions and special rules (temporary).

(a)(1) through (a)(2) [Reserved]. For further guidance, see § 1.988–1(a)(1) through (2).

(3) *Specified owner functional currency transactions of a section 987 QBU not treated as section 988 transactions*. Specified owner functional currency transactions, as defined in § 1.987–3T(b)(4)(ii), held by a section 987 QBU are not treated as section 988 transactions. Thus, no currency gain or loss shall be recognized by a section 987 QBU under

section 988 with respect to such transactions.

(4) through (i) [Reserved]. For further guidance, see § 1.988–1(a)(4) through (i).

(j) *Effective/applicability date*. This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date*. The applicability of this section expires on December 6, 2019.

Par. 22. Section 1.988–2 is amended by revising paragraph (b)(16) and adding paragraph (i) to read as follows:

§ 1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(16) [Reserved]. For further guidance, see § 1.988–2T(b)(16).

* * * * *

(i) [Reserved]. For further guidance, see § 1.988–2T(i).

Par. 23. Section 1.988–2T is added to read as follows:

§ 1.988–2T Recognition and computation of exchange gain or loss (temporary).

(a) through (b)(15) [Reserved]. For further guidance, see § 1.988–2(a) through (b)(15).

(16) *Deferral of loss on certain related-party debt instruments*.—(i) *Treatment of creditor*. For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see § 1.267(f)–1(e).

(ii) *Treatment of debtor*—(A) *In general*. Exchange loss realized under § 1.988–2(b)(4) or (b)(6) is deferred if—

(*1*) The loss is realized by a debtor with respect to a loan from a person that has a relationship to the debtor described in section 267(b) or section 707(b); and

(*2*) The transaction resulting in the realization of exchange loss has as a principal purpose the avoidance of Federal income tax.

(B) *Recognition of deferred loss*. Any exchange loss that is deferred under paragraph (b)(16)(ii)(A) of this section is deferred until the end of the term of the loan, determined immediately prior to the transaction.

(17) through (h) [Reserved]. For further guidance, see § 1.988–2(b)(17) through (h).

(i) *Special rules for section 988 transactions of a section 987 QBU*. For rules regarding section 988 transactions of a section 987 QBU, see § 1.987–3T(b)(4) for section 987 QBUs in general and § 1.987–1T(b)(6) for dollar QBUs.

(j) *Effective/applicability date*. Paragraph (b)(16) of this section applies to any exchange loss realized on or after December 7, 2016. Paragraph (i) of this section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then paragraph (i) of this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date*. The applicability of this section expires on December 6, 2019.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 14, 2016,

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 7, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 8, 2016, 81 F.R. 88854)

T.D. 9801

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Issue Price Definition for Tax-Exempt Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the definition of issue price for purposes of the arbitrage investment restrictions that apply to tax-exempt bonds and other tax-advantaged bonds. These final regulations affect State and local governments that issue tax-exempt bonds and other tax-advantaged bonds.

DATES: *Effective date*: These regulations are effective on December 9, 2016.

Applicability date: For the date of applicability, see § 1.148–11(m).

FOR FURTHER INFORMATION CONTACT:
Lewis Bell at (202) 317-6980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1347. The collection of information in these final regulations is in § 1.148–1(f)(2)(ii), which requires the underwriter to provide to the issuer a certification and reasonable supporting documentation for use of the initial offering price to the public, § 1.148–1(f)(2)(iii), which requires the issuer to obtain a certification from the underwriter for competitive sales, and § 1.148–1(f)(2)(iv), which requires the issuer to identify in its books and records the rule used to determine the issue price of the bonds. The respondents are issuers of tax-exempt bonds that want to apply the special rules in § 1.148–1(f)(2) to determine the issue price of the bonds.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by section 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) on the arbitrage investment restrictions under section 148 of the Internal Revenue Code (Code). On June 18, 1993, the Department of the Treasury (Treasury Department) and the IRS published comprehensive final regulations in the **Federal Register** (TD 8476, 58 FR 33510) on the arbitrage investment restrictions and related provisions for tax-exempt bonds under sections 103, 148, 149, and 150. Since that time, those final regulations have been amended in various limited respects, including most recently in final regulations published in the **Federal Register** (TD 9777, 81 FR 46582) on July 18, 2016 (the regulations issued in 1993 and the various amendments thereto are collectively referred to as the Existing Regulations).

A notice of proposed rulemaking was published in the **Federal Register** (78 FR 56842; REG–148659–07) on September 16, 2013 (the 2013 Proposed Regulations), which, among other things, proposed to amend the definition of "issue price." Subsequently, the Treasury Department and the IRS withdrew § 1.148–1(f) of the 2013 Proposed Regulations regarding the definition of issue price and published another notice of proposed rulemaking in the **Federal Register** (80 FR 36301; REG–138526–14) on June 24, 2015, which re-proposed a definition of issue price (the 2015 Proposed Regulations). Comments were received and a public hearing was held on October 28, 2015. After consideration of all of the public comments, the Treasury Department and the IRS adopt the 2015 Proposed Regulations, with revisions, by this Treasury decision (the Final Regulations).

Summary of Comments and Explanation of Provisions

This section discusses the comments received from the public regarding the 2015 Proposed Regulations. The comments are available for public inspection at *www.regulations.gov*. This section also explains revisions made in the Final Regulations.

1. *Introduction.*

Under section 103, interest received by investors on eligible State and local bonds is exempt from Federal income tax. As a result, tax-exempt bonds tend to have lower interest rates than taxable obligations. Section 148 generally limits investment of proceeds of tax-exempt bonds to investment yields that are not materially higher than the yield on the bond issue. Section 148 also generally requires that excess investment earnings be paid to the Federal Government at periodic intervals. For purposes of these arbitrage investment restrictions, section 148(h) provides that yield on an issue is to be determined on the basis of the issue price (within the meaning of sections 1273 and 1274). The reason for using issue price (rather than sales proceeds less the costs of issuance) to determine yield for purposes of section 148(h) is to ensure that issuers bear the costs of issuance, rather than recover these costs through arbitrage profits. See H. Rep. No. 99–426, at 517 (1985). The report of the Committee on Ways and Means states that the Committee believed that this requirement would encourage issuers to scrutinize costs of issuance more closely and would encourage better targeting of the federal subsidy associated with tax-exempt bonds. Id., at 517–518. In general, the lower the issue price for bonds bearing a stated interest rate, the higher the yield. An issuer has an economic incentive to receive the highest price for bonds and to pay the lowest yield. This aligns with the purpose of the arbitrage restrictions, which is to minimize arbitrage investment benefits and remove incentives to issue more tax-exempt bonds, and thus to limit the federal revenue cost of the tax subsidy for tax-exempt bonds.

The issue price definition under the Existing Regulations generally follows the issue price definition used for computing original issue discount on debt instruments under sections 1273 and 1274, with certain modifications. The definition of issue price under the Existing Regulations provides generally that the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. The Existing Regulations define a substantial amount to mean ten percent. Further, the Existing Regulations include a special rule that applies a reasonable expectations standard (rather than a standard based on actual sales) to determine, as of the sale date,[12] the issue price for bonds for which a bona fide public offering is made, based on reasonable expectations regarding the initial offering price. The issue prices of bonds with different payment and credit terms are determined separately. Tax-exempt bond issues often include bonds with different payment and credit terms that generally sell at different prices.

The special rule in the Existing Regulations that provides for the determination of issue price as of the sale date based on reasonable expectations about the initial public offering price aims, in part, to provide certainty that the bonds will qualify as tax-exempt bonds and meet State or local requirements for debt issuance. Generally, the sale date is the date when the syndicate or sole underwriter in contractual privity with the issuer signs the agreement to buy the bonds from the issuer and when the terms of the bond issue are set. In the municipal bond market, due largely to the serial maturity structure and, in many cases, an inability to sell a substantial amount of each of the different maturities of the bonds with different terms (for which issue price must be determined separately) by the sale date, issuers may have difficulties in establishing the issue price of all of the bonds included within an issue by the sale date, unless a special rule is available.

2. *General Rule: Actual Sale of a Substantial Amount of Bonds.*

Consistent with section 148(h), the 2015 Proposed Regulations proposed to retain the rule that issue price generally will be determined under the rules of sections 1273 and 1274. The 2015 Proposed Regulations also proposed a general rule similar to that in the regulations under

[12] Under § 1.150–1(c)(6), the sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond. By comparison, under § 1.150–1(b), the issue date for a bond is the date on which the issuer receives the purchase price in exchange for that bond, commonly referred to as the closing date or settlement date.

section 1273 that the issue price of bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. The 2015 Proposed Regulations proposed to retain the rule in the Existing Regulations that ten percent is the measure of a substantial amount. The 2015 Proposed Regulations also proposed to retain the rule that the issue prices of bonds with different payment and credit terms are determined separately.

Commenters recommended adding an express rule to address the treatment of private placements (for example, bank loans), which in the municipal bond industry typically do not involve underwriters. Commenters also recommended clarifying that an issuer may use the general rule to determine issue price even if the issuer had sought to use the special rule based on the initial offering price to the public discussed in section 3 of this preamble. The Treasury Department and the IRS agree with these recommendations.

The Final Regulations retain the rules in the Existing Regulations and the general rule of the 2015 Proposed Regulations that, for bonds issued for money, the issue price is the first price at which a substantial amount of the bonds is sold to the public, and a substantial amount is ten percent. In addition, in response to comments, the Final Regulations expressly provide that, for a bond issued for money in a private placement to a single buyer that is not an underwriter or a related party (as defined in § 1.150–1(b)) to an underwriter, the issue price of the bond is the price paid by that buyer. Further, the Final Regulations clarify that for bonds for which more than one rule for determining issue price is available, for example, the general rule and one of the special rules discussed in sections 3 and 4 of this preamble, an issuer may select the rule it will use to determine the issue price for the bonds at any time on or before the issue date of the bonds. On or before the issue date of the bonds, the issuer must identify the rule selected in its books and records maintained for the bonds.

A commenter suggested that a specific time on the sale date should be established as the proper time for determining issue price. The Treasury Department and the IRS understand that it has been a longstanding practice to determine issue price on the sale date without regard to a specific time and that it is unlikely for bonds to be sold to the public at different prices on that date. Thus, the imposition of a specific time deadline for such determination seems unnecessary and would add to the administrative burden. The Final Regulations do not adopt this comment.

3. *Special Rule for Use of the Initial Offering Price to the Public.*

The 2015 Proposed Regulations proposed a special rule that would allow an issuer to treat the initial offering price to the public as the issue price as of the sale date, provided certain requirements were met. That proposed special rule (referred to as the "alternative method" in the 2015 Proposed Regulations) proposed to require that the lead underwriter (or sole underwriter, if applicable) certify certain matters, including that no underwriter would sell bonds after the sale date and before the issue date at a price higher than the initial offering price except if the higher price was the result of a market change for the bonds after the sale date (for example, due to a change in market interest rates), and that the lead underwriter provide the issuer with supporting documentation for the matters covered by the certifications, including a justification for any higher price based on a market change. (This proposed requirement for underwriters generally to hold the price at no higher than the initial offering price to the public until the issue date is sometimes referred to herein as the "hold-the-offering-price" requirement.)

Commenters favored a special rule to allow use of the initial offering price to the public to set the issue price as of the sale date. Numerous commenters, however, expressed concerns about various aspects of the eligibility requirements for this proposed special rule. One concern expressed by underwriters was that the requirement for the lead underwriter to provide certification as to the actions of the entire underwriting syndicate or selling group was overly broad. Instead, underwriters recommended allowing members of an underwriting syndicate or a selling group to agree individually to act in accordance with the specific matters required under the special rule. The Final Regulations adopt the comment that each underwriter is individually or severally responsible for its agreement (rather than jointly responsible with other underwriters).

Several commenters suggested that the hold-the-offering-price requirement would result in lower offering prices and should not be included in the special rule. One concern expressed related to the differing time periods between the sale date and the issue date for various issuers. One commenter recommended limiting the time period for holding the price to six business days after the sale date. Further, notwithstanding the potential flexibility in pricing afforded by the proposed market change exception to the hold-the-offering-price requirement, commenters overwhelmingly objected to this exception as unworkable because of the absence of meaningful benchmarks for municipal bond prices. Commenters also expressed concern that use of this exception could lead to audit disputes over appropriate documentation to support such price changes.

Accordingly, the Final Regulations adopt a modified hold-the-offering-price requirement that requires underwriters to hold the price for offering and selling unsold bonds at a price that is no greater than the initial offering price to the public for a shorter time period that ends on the earlier of (1) the close of the date that is the fifth (5th) business day after the sale date or (2) the date on which the underwriters have sold a substantial amount of the bonds to the public. Further, in response to the overwhelming negative comments about the proposed market change exception to the proposed hold-the-offering-price requirement, the Final Regulations omit the market change exception.

The modified hold-the-offering-price requirement in the Final Regulations provides a standardized time period for application of the requirement to bonds regardless of the differing time periods among issuers between sales and closings of municipal bond issues. Further, the shorter time period for this requirement should reduce potential associated risks to underwriters and thereby limit the effects of this requirement on initial pricing to issuers and, at the same time, ensure that market pricing behavior is consistent with the initial offering price used for issue price determinations.

Two commenters suggested confirming that, for purposes of the hold-the-offering-price requirement, an underwriter may sell bonds to anyone at a price that is lower (rather than higher) than the initial offering price to the public under this special rule. This special rule expressly provides for this result under the Final Regulations. One commenter sought clarification that underwriters may sell bonds to other underwriters at prices that are higher than the initial offering price to the public under this special rule. Sales to underwriters at such higher prices are inconsistent with a purpose of this special rule to use the initial offering price to the public as a proxy for the issuer's agreement with the underwriters about the maximum amount of underwriters' compensation that is reflected in setting the issue price. Thus, the Final Regulations clarify that underwriters may not sell the bonds at a price that is higher than the initial offering price to the public.

Several commenters recommended a different special rule that would base determinations of issue price on sales of an aggregate percentage of all of the bonds included within an issue, as distinguished from the bond-by-bond method required to determine issue price for bonds with different interest rates, maturities, credits, or payment terms under the Existing Regulations and the 2015 Proposed Regulations. Commenters recommended different percentages of sales of aggregate principal amounts of bonds within an issue to determine issue price, including 25 percent, 50 percent, and 65 percent.

Although a rule that would focus on actual sales of greater percentages of the aggregate principal amounts of bonds included within an issue to determine issue price has potential utility, the Treasury Department and the IRS have concerns about the comparability of the terms of unsold bonds with the terms of sold bonds, which would serve as a proxy for setting the issue price of the unsold bonds, and about the attendant potential complexity to ensure appropriate comparability. Further, the Treasury Department and the IRS have concerns about selection of an appropriate percentage of aggregate sales for such a rule and whether issuers would be able to sell the required percentage of the aggregate principal amount of bonds within the issue. The public comments did not reflect any consensus on an appropriate percentage of aggregate sales for such a rule. In addition, several of the comments in favor of such a rule focused particularly on the need for a more workable rule for competitive sales. In response to this concern, the Final Regulations provide a simplified special rule for competitive sales, as described in section 4 of this preamble. Accordingly, the Final Regulations do not adopt a rule that would focus on actual sales of greater percentages of the aggregate principal amounts of bonds included within an issue.

In summary, the Final Regulations provide a special rule under which an issuer may treat the initial offering price to the public as the issue price of the bonds as of the sale date if: (1) The underwriters offered the bonds to the public at a specified initial offering price on or before the sale date, and the lead underwriter in the underwriting syndicate or selling group (or, if applicable, the sole underwriter) provides, on or before the issue date, a certification to that effect to the issuer, together with reasonable supporting documentation for that certification, such as a copy of the pricing wire or equivalent communication; and (2) each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price that is higher than the initial offering price during the period starting on the sale date and ending on the earlier of the close of the fifth (5th) business day after the sale date, or the date on which the underwriters have sold a substantial amount of the bonds to the public at a price that is no higher than the initial offering price to the public.

4. *Special Rule for Competitive Sales.*

Numerous commenters, including four States, strongly urged a streamlined special rule for competitive sales to allow the reasonably expected initial offering price to the public reflected in the winning bid in a competitive sale to establish the issue price without a hold-the-offering-price requirement or other restrictions. Commenters suggested that the public bidding process for pricing municipal bonds in competitive sales itself provides a sufficient basis to achieve the best pricing for issuers. The Treasury Department and the IRS recognize that competitive sales favor competition and price transparency that may result in better pricing for issuers. The Final Regulations adopt these comments and provide that, for bonds issued for money pursuant to an eligible competitive sale, an issuer may treat the reasonably expected initial offering price to the public of the bonds as the issue price of the bonds as of the sale date if the issuer obtains a certification from the winning bidder regarding the reasonably expected initial offering price to the public of the bonds upon which the price in the winning bid is based.

For purposes of this special rule, the Final Regulations define *competitive sale* to mean a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process in which the issuer offers the bonds for sale to underwriters at specified written terms and that meets the following requirements: (1) The issuer disseminates the notice of sale to potential underwriters in a manner reasonably designed to reach potential underwriters; (2) all bidders have an equal opportunity to bid; (3) the issuer receives bids from at least three underwriters of municipal bonds who have established industry reputations for underwriting new issuances of municipal bonds; and (4) the issuer awards the sale to the bidder who offers the highest price (or lowest interest cost).

5. *Definitions*

The 2015 Proposed Regulations proposed to define the term "public" for purposes of determining the issue price of tax-exempt bonds to mean any person other than an underwriter or a related party to an underwriter. Several commenters recommended expanding the definition of public to include related parties to underwriters. This recommended change would allow various affiliates of underwriters, such as entities involved in proprietary trading, to qualify as members of the public for purposes of determining issue price. The Final Regulations do not adopt this comment. The Final Regulations retain this related party restriction on the definition of the public as a safeguard to protect against potential abuse.

The 2015 Proposed Regulations proposed to define "underwriter" to include: (1) Any person that contractually agrees to participate in the initial sale of the bonds to the public by entering into a contract with the issuer or into a contract with a lead underwriter to form an underwriting syndicate and (2) any person that, on or before the sale date, directly or indirectly enters into a contract or other arrangement with any of the foregoing to sell the bonds. Numerous commenters expressed significant concern that the phrase "other arrangement" in the definition of underwriter was vague and unworkable. One commenter asked if distribution arrangements (for example, a retail distribution contract between a member of an underwriting syndicate or selling group and another dealer that is not in the syndicate or selling group) were included. Another commenter suggested changes to clarify that a contract to sell the bonds be limited to a contract with respect to the initial sale of the bonds to the public. In response to these comments, the Final Regulations omit the phrase "or other arrangement" from the definition of underwriter. The Final Regulations also clarify that covered agreements must relate to the initial sale of the bonds to the public and that these agreements include retail distribution agreements.

6. *Standard for Reliance on Certifications and Consequences of Violations.*

The 2015 Proposed Regulations proposed a standard that would limit an issuer's ability to rely on certifications from underwriters to circumstances in which an issuer did not know or have reason to know, after exercising due diligence, that the certifications were false. Several commenters expressed concerns about this proposed standard for reliance on certifications. One commenter expressed particular concern that the proposed standard appeared to be higher than or different from the general due diligence standard for determining reasonable expectations that bonds are not arbitrage bonds under § 1.148–2(b) of the Existing Regulations. The existing definition of reasonable expectations, found in § 1.148–1(b) of the Existing Regulations, treats an issuer's expectations or actions as reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. One commenter also sought confirmation that issuers could rely on certifications from underwriters without independent verification.

In response to the comments, the Final Regulations omit the proposed special standard for reliance on underwriters' certifications. Instead, the existing due diligence standard under the Existing Regulations for reasonable expectations or reasonableness will apply to any certification under the Final Regulations. For example, this existing due diligence standard will apply under the special rule on competitive sales to an issuer's reliance on a certification from the winning bidder regarding the reasonably expected initial offering price to the public of the bonds upon which the price in the winning bid is based.

Several commenters urged providing conclusive legal certainty for issue price determinations as of the sale date based on receipt of required underwriter certifications without regard to whether such certifications subsequently proved to be false. Although the Final Regulations generally will allow issuers to establish the issue price as of the sale date, the Final Regulations do not adopt this comment. Accordingly, a failure to meet a specific eligibility requirement of a rule for determining issue price, such as an underwriter's breach of its hold-the-offering-price agreement under the special rule for use of initial offering price, will result in a failure to establish issue price under that rule and a redetermination of issue price under a different rule. The potential invalidation of an issue price determination is important to ensure compliance with the arbitrage restrictions and the legal availability of penalties against underwriters for false statements. A false statement by an underwriter in a certification or in the agreement among underwriters under one of these special rules may result in a penalty against the underwriter under section 6700, depending on the facts and circumstances.

In accordance with section 6001, the issuer must maintain reasonable documentation in its books and records to support its issue price determinations. In addition, the Final Regulations require that the issuer obtain from the underwriter certain certifications and other reasonable supporting documentation such as a pricing wire to establish its issue price determination under a specific rule in the Final Regulations. A certification from the underwriter of the first price at which ten percent of the bonds were sold to the public is an example of reasonable supporting documentation to establish the issue price of the bonds under the general rule in the Final Regulations.

7. *Other Comments*

A commenter requested a special rule under section 148 to determine issue price in a debt-for-debt exchange, including an exchange resulting from a significant modification under § 1.1001–3. Under the special rule, an issuer would have the option to use a tax-exempt bond's stated principal amount as the issue price rather than the issue price that otherwise would apply under section 1273 or 1274. The commenter requested the rule because, in the commenter's experience, the stated interest rate on a tax-exempt bond issued in a debt-for-debt exchange was generally less than the adjusted applicable Federal rate (AAFR) used under section 1288 to determine whether the bond has adequate stated interest for purposes of section 1274. In this situation, the issue price of the bond would be less than the bond's stated principal amount, resulting in an arbitrage yield that is higher than it otherwise would be if the bond were treated as issued for an amount equal to the bond's stated principal amount. The Final Regulations do not include such a rule because, since the date of the commenter's request, the method to determine the AAFR has been modified in TD 9763, 81 FR 24482 (April 26, 2016). As a result of this modification, it is more likely that the issue price of a tax-exempt bond issued in a debt-for-debt exchange will be the bond's stated principal amount under section 1273 or 1274 (for example, because the AAFR will not be greater than the corresponding applicable Federal rate for taxable bonds, as it was in certain years before the modification).

In addition, some commenters recommended allowing the use of issue price as defined for arbitrage purposes in applying various limitations for other tax-exempt bond purposes, such as those based on principal amounts, face amounts, and sale proceeds. The Final Regulations do not adopt this recommendation because it raises issues that are beyond the scope of the 2015 Proposed Regulations, and the recommended extension of the application of the definition of issue price beyond arbitrage purposes appropriately warrants a separate opportunity for public comment. The Treasury Department and the IRS, however, expect to consider this recommendation in connection with future guidance.

Applicability Date

The Final Regulations apply to bonds that are sold on or after June 7, 2017.

Special Analyses

Certain IRS regulations, including these Final Regulations, are exempt from the requirements of Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory impact assessment is not required.

It is hereby certified that these Final Regulations will not have a significant economic impact on a substantial number of small entities. This certification is based generally on the fact that any effect on small entities by these rules generally flows from section 148 of the Code. Section 148(h) of the Code requires the yield on an issue of bonds to be determined on the basis of issue price (within the meaning of sections 1273 and 1274). Under section 1273(b), the issue price is the first price at which a substantial amount of the bonds is sold to the public. Section 1.148–1(f)(2) of the Final Regulations gives effect to the statute by requiring the issuer to (1) obtain certain documentation from the underwriter, which is the party that sells the bonds to the public, to support the issuer's determination of issue price and (2) indicate in its books and records the rule used by the issuer to determine issue price. This information will be used to support the issue price of the bonds for audit and other purposes. Any economic impact of obtaining this information is minimal because most of the information already is provided to issuers by the underwriters under existing industry practices. Accordingly, these changes do not add to the impact on small entities imposed by the statutory provision. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the 2015 Proposed Regulations preceding these Final Regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Drafting Information

The principal authors of these regulations are Johanna Som de Cerff and Lewis Bell, Office of Associate Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.148–0(c) is amended by adding entries for §§ 1.148–1(f) and 1.148–11(m) to read as follows:

§ 1.148–0 Scope and table of contents.

* * * * *

(c) * * *

§ 1.148–1 Definitions and elections.

* * * * *

(f) Definition of issue price.
(1) In general.
(2) Bonds issued for money.
(3) Definitions.
(4) Other special rules.

* * * * *

§ 1.148–11 Effective/applicability dates.

* * * * *

(m) Definition of issue price.

Par. 3. Section 1.148–1 is amended by revising the definition of issue price in paragraph (b) and adding paragraph (f) to read as follows:

§ 1.148–1 Definitions and elections.

* * * * *

(b) * * *

Issue price means issue price as defined in paragraph (f) of this section.

* * * * *

(f) *Definition of issue price*—(1) *In general*. Except as otherwise provided in this paragraph (f), "issue price" is defined in sections 1273 and 1274 and the regulations under those sections.

(2) *Bonds issued for money*—(i) *General rule*. Except as otherwise provided in this paragraph (f)(2), the issue price of bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. If a bond is issued for money in a private placement to a single buyer that is not an underwriter or a related party (as defined in § 1.150–1(b)) to an underwriter, the issue price of the bond is the price paid by that buyer. Issue price is not reduced by any issuance costs (as defined in § 1.150–1(b)).

(ii) *Special rule for use of initial offering price to the public*. The issuer may treat the initial offering price to the public as of the sale date as the issue price of the bonds if the requirements of paragraphs (f)(2)(ii)(A) and (B) of this section are met.

(A) The underwriters offered the bonds to the public for purchase at a specified initial offering price on or before the sale date, and the lead underwriter in the underwriting syndicate or selling group (or, if applicable, the sole underwriter) provides, on or before the issue date, a certification to that effect to the issuer, together with reasonable supporting documentation for that certification, such as a copy of the pricing wire or equivalent communication.

(B) Each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price that is higher than the initial offering price to the public during the period starting on the sale date and ending on the earlier of the following:

(*1*) The close of the fifth (5th) business day after the sale date; or

(*2*) The date on which the underwriters have sold a substantial amount of the bonds to the public at a price that is no higher than the initial offering price to the public.

(iii) *Special rule for competitive sales*. For bonds issued for money in a competitive sale, an issuer may treat the reasonably expected initial offering price to the public as of the sale date as the issue price of the bonds if the issuer obtains from the winning bidder a certification of the bonds' reasonably expected initial offering price to the public as of the sale date upon which the price in the winning bid is based.

(iv) *Choice of rule for determining issue price*. If more than one rule for determining the issue price of the bonds is available under this paragraph (f)(2), at any time on or before the issue date, the issuer may select the rule it will use to determine the issue price of the bonds. On or before the issue date of the bonds, the issuer must identify the rule selected in its books and records maintained for the bonds.

(3) *Definitions*. For purposes of this paragraph (f), the following definitions apply:

(i) *Competitive sale* means a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process in which the issuer offers the bonds for sale to underwriters at specified written terms, if that process meets the following requirements:

(A) The issuer disseminates the notice of sale to potential underwriters in a manner that is reasonably designed to reach potential underwriters (for example, through electronic communication that is widely circulated to potential underwriters by a recognized publisher of municipal bond offering documents or by posting on an Internet-based Web site or other electronic medium that is regularly used for such purpose and is widely available to potential underwriters);

(B) All bidders have an equal opportunity to bid (within the meaning of § 1.148–5(d)(6)(iii)(A)(*6*));

(C) The issuer receives bids from at least three underwriters of municipal bonds who have established industry reputations for underwriting new issuances of municipal bonds; and

(D) The issuer awards the sale to the bidder who submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).

(ii) *Public* means any person (as defined in section 7701(a)(1)) other than an underwriter or a related party (as defined in § 1.150–1(b)) to an underwriter.

(iii) *Underwriter* means:

(A) Any person (as defined in section 7701(a)(1)) that agrees pursuant to a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to participate in the initial sale of the bonds to the public; and

(B) Any person that agrees pursuant to a written contract directly or indirectly with a person described in paragraph (f)(3)(iii)(A) of this section to participate in the initial sale of the bonds to the public (for example, a retail distribution agreement between a national lead underwriter and a regional firm under which the regional firm participates in the initial sale of the bonds to the public).

(4) *Other special rules*. For purposes of this paragraph (f), the following special rules apply:

(i) *Separate determinations*. The issue price of bonds in an issue that do not have the same credit and payment terms is determined separately. The issuer need not apply the same rule to determine issue price for all of the bonds in the issue.

(ii) *Substantial amount*. Ten percent is a substantial amount.

(iii) *Bonds issued for property*. If a bond is issued for property, the adjusted applicable Federal rate, as determined under section 1288 and § 1.1288–1, is used in lieu of the applicable Federal rate to determine the bond's issue price under section 1274.

Par. 4. Section 1.148–11 is amended by adding paragraph (m) to read as follows:

§ 1.148–11 Effective/applicability dates.

* * * * *

(m) *Definition of issue price*. The definition of issue price in § 1.148–1(b) and (f) applies to bonds that are sold on or after June 7, 2017.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 22, 2016,

Mark J. Mazur,
Assistant Secretary of the Treasury for Tax Policy.

(Filed by the Office of the Federal Register on December 8, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 9, 2016, 81 F.R. 88999)

Section 301.—Distributions of property

26 CFR 301.6103(j)(1)–1T: Disclosures of return information reflected on returns to officers and employees of the Department of Commerce for Certain Statistical

T.D. 9802

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Disclosures of Return Information Reflected on Returns to Officers and Employees of the Department of Commerce for Certain Statistical Purposes and Related Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that authorize the disclosure of certain items of return information to the Bureau of the Census (Bureau) in conformance with section 6103(j)(1) of the Internal Revenue Code (Code). These temporary regulations are made pursuant to a request from the Secretary of Commerce. These temporary regulations also provide clarifying language for an item of return information and remove duplicative paragraphs contained in the existing regulations. These temporary regulations require no action by taxpayers and have no effect on their

tax liabilities. Thus, no taxpayers are likely to be affected by the disclosures authorized by this guidance. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Bulletin**.

DATES: *Effective Date:* These temporary regulations are effective on December 9, 2016.

Applicability Date: For dates of applicability, see § 301.6103(j)(1)–1T(e).

FOR FURTHER INFORMATION CONTACT: William Rowe, (202) 317-6834 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains amendments to 26 CFR part 301. Section 6103(j)(1)(A) of the Internal Revenue Code authorizes the Secretary of the Treasury (Secretary) to furnish, upon written request by the Secretary of Commerce, such returns or return information as the Secretary may prescribe by regulation to officers and employees of the Bureau for the purpose of, but only to the extent necessary in, the structuring of censuses and national economic accounts and conducting related statistical activities authorized by law. Section 301.6103(j)(1)–1 of the existing regulations further defines such purposes by reference to 13 U.S.C. chapter 5 and provides an itemized description of the return information authorized to be disclosed for such purposes.

By letter dated August 2, 2016, the Secretary of Commerce requested amendments to § 301.6103(j)(1)–1 to allow disclosure of several additional items of return information to the Bureau for purposes of its economic statistics program, structuring the censuses, and related program evaluations. The Secretary of Commerce's letter lists the additional items of return information requested based on the Bureau's specific need for each item of information.

The Secretary of Commerce's letter requested additional expense items from business tax returns in order to improve the expense data that is collected by the Bureau. Specifically, the Secretary of Commerce requested disclosure of the following enumerated components of total expenses or total deductions from business tax returns (Forms 1065, Forms in the 1120 series, and Form 1040, Schedule C, E or C/EZ): (1) repairs (and maintenance) expense; (2) rents (or lease) expense; (3) taxes and licenses expense; (4) interest expense, including mortgage or other interest; (5) depreciation expense; (6) depletion expense; (7) advertising expense; (8) pension and profit-sharing plans (retirement plans) expense; (9) employee benefit programs expense; (10) utilities expense; (11) supplies expense; (12) contract labor expense; and (13) management (and investment advisory) fees. The Secretary of Commerce has also requested purchases from Form 1125–A and the following additional items from Form 1040, Schedule C: (1) materials and supplies; and (2) purchases less cost of items withdrawn for personal use. The Secretary of Commerce determined that these additional items are needed to evaluate the quality of expense data collected from surveys and to improve the Bureau's imputation models as the Bureau faces a trend of rising non-response rates in its surveys.

The Secretary of Commerce's letter also requested additional items of return information from business tax returns for the purpose of directing a high proportion of research and development surveys towards businesses with known research activities. Specifically, the Secretary of Commerce requested the following additional items of return information from Forms 6765 (when filed with corporation income tax returns): (1) cycle posted; and (2) the research tax credit amount to be carried over to a business return, schedule, or form. The Secretary of Commerce determined that the amount of research tax credit is needed to improve the coverage and reliability of surveys that collect research and development data, and determined that the cycle posted is needed in order to align the research tax credit with the appropriate survey year for sampling purposes.

The Secretary of Commerce's letter also requested additional items of return information for purposes of maintaining a centralized, continuous Business Register that comprehensively lists and characterizes United States business establishments and their domestic parent enterprises. The Business Register provides the central business list necessary to support the Bureau's economic census and survey activities. Specifically, the Secretary of Commerce requested the following additional items of return information from employment tax returns: (1) if a business has closed or stopped paying wages; (2) final date a business paid wages; and (3) if a business is a seasonal employer and does not have to file a return for every quarter of the year. The Secretary of Commerce has determined that these items of return information are vital to reducing or eliminating costly mailings to businesses that have closed or are seasonal in nature. The Secretary of Commerce also requested the electronic system filing indicator from business tax returns and the cycle from the IRS's Business Master Files. The Secretary of Commerce determined that the electronic system filing indicator is needed to help establish the ideal survey mode for a particular entity (electronic or paper reporting forms).

The Secretary of Commerce's letter also requested additional items of return information for purposes of modeling firm survival for production of statistics on business dynamics. Specifically, the Secretary of Commerce has requested the following additional items of return information from business tax returns: (1) dividends, including ordinary and qualified; and (2) type of REIT (from Form 1120–REIT). The Secretary of Commerce has determined that these items are needed to estimate models of firm survival and to estimate an owner's percentage of capital.

The Secretary of Commerce's letter also requested additional items of return information for purposes of the Survey of Business Owners. Specifically, the Secretary of Commerce has requested the following additional items of return information from Form 1065, Schedule K–1: (1) publicly-traded partnership indicator; (2) partner's share of nonrecourse, qualified nonrecourse, and recourse liabilities; and (3) ordinary business income (loss). The Secretary of Commerce has also requested ordinary business income (loss) from Forms 1120S, Schedule K–1. The Secretary of Commerce has determined that the ordinary business income (loss) and partner's share of liabilities items are needed in order to ascertain which owner's demographic information to use for the entity and as a proxy for ownership share of the partner. The publicly-traded partnership indicator is needed to save the cost of mailing surveys to publicly-traded partnerships since it is unlikely that publicly-traded partnerships could accurately provide demographic information about their owners.

Finally, the Secretary of Commerce's letter also requested additional items of return information for purposes of developing and preparing the Quarterly Financial Report. Specifically, the Secretary of Commerce requested the following additional items of return information from Forms 1120–REIT: (1) type of Real Estate Investment Trust ("REIT"); and (2) gross rents from real property. The Secretary of Commerce also requested the corporation's method of accounting from Form 1120F and the total amount reported from Form 1096. The Secretary of Commerce determined that gross rents from real property is needed to design and select the annual Quarterly Financial Report sample, and that the type of REIT is needed for editing and imputation purposes in the event that there are characteristic differences between the types of REITs. The Secretary of Commerce determined that the corporation's method of accounting is needed to understand how businesses with different accounting methods might report differently in the Quarterly Financial Report surveys. The Secretary of Commerce has determined that the total amounts reported from Form 1096 are needed to measure labor inputs for productivity since it would provide information on labor costs not covered by administrative records or survey reports of payroll.

The Secretary of Commerce asserted that good cause exists to amend § 301.6103(j)(1)–1 of the regulations to add these additional items to the list of items of return information that may be disclosed to the Bureau. The Treasury Department and the IRS agree that amending existing regulations to permit disclosure of these items to the Bureau is appropriate to meet the needs of the Bureau. These temporary regulations amend the existing regulations to allow disclosure of the items requested by the Secretary of Commerce.

This temporary regulation also amends language in the existing regulations to clarify that the T.D. 9500, which was published in the **Federal Register** (75 F.R. 52458), authorized disclosure only of categorical information for total qualified research expenses from Forms 6765. In accordance with the preamble to T.D. 9500, the existing regulations do not authorize the disclosure of the exact amount of total research expenses as reported on Form 6765. By letter dated February 6, 2006, the Secretary of Commerce requested disclosure of categorical information on total qualified research expenses in three ranges: greater than zero, but less than $1 million; greater than or equal to $1 million, but less than $3 million; and, greater than or equal to $3 million. These temporary regulations amend the existing regulations to more clearly reflect the categorical nature of the disclosure of total research expenses from Form 6765.

Lastly, this temporary regulation also removes duplicate paragraphs contained in the existing regulations. Under the existing regulations, each of the following items of return information from business-related returns was authorized for disclosure by two identical paragraphs: Social Security tip income; total Social Security taxable earnings; and gross distributions from employer-sponsored and individual retirement plans from Form 1099–R. Because there is no need for duplicate paragraphs that authorize disclosure of the same items of return information for the same purpose, the duplicate paragraphs are removed.

The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Bulletin**.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities because the regulations do not impose a collection of information on small entities. Accordingly, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of these temporary regulations is William Rowe, Office of the Associate Chief Counsel (Procedure & Administration).
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Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—-PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 301.6103(j)(1)–1T is added to read as follows:

§ 301.6103(j)(1)–1T Disclosures of return information reflected on returns to officers and employees of the Department of Commerce, for certain statistical purposes and related activities (Temporary).

(a) through (b)(2)(iii)(H) [Reserved]. For further guidance see § 301.6103(j)(1)–1(a) through (b)(2)(iii)(H).

(I) Total taxable wages paid for purposes of chapter 21;

(J) [Reserved]. For further guidance see § 301.6103(j)(1)–1(b)(2)(iii)(J).

(K) If a business has closed or stopped paying wages;

(L) Final date a business paid wages; and

(M) If a business is a seasonal employer and does not have to file a return for every quarter of the year;

(b)(2)(iv) through (b)(3)(iv) [Reserved]. For further guidance see § 301.6103(j)(1)–1(b)(2)(iv) through (b)(3)(iv).

(v) Total expenses or deductions, including totals of the following components thereof:

(A) Repairs (and maintenance) expense;

(B) Rents (or lease) expense;

(C) Taxes and licenses expense;

(D) Interest expense, including mortgage or other interest;

(E) Depreciation expense;

(F) Depletion expense;

(G) Advertising expense;

(H) Pension and profit-sharing plans (retirement plans) expense;

(I) Employee benefit programs expense;

(J) Utilities expense;

(K) Supplies expense;

(L) Contract labor expense; and

(M) Management (and investment advisory) fees.

(b)(3)(vi) through (b)(3)(xxiv) [Reserved]. For further guidance see § 301.6103(j)(1)–1(b)(3)(vi) through (b)(3)(xxiv).

(xxv) From Form 6765 (when filed with corporation income tax returns)—

(A) Indicator that total qualified research expenses is greater than zero, but less than $1 million; greater than or equal to $1 million, but less than $3 million; or, greater than or equal to $3 million;

(B) Cycle posted; and

(C) Research tax credit amount to be carried over to a business return, schedule, or form.

(xxvi) Total number of documents reported on Form 1096 transmitting Forms 1099–MISC.

(xxvii) Total amount reported on Form 1096 transmitting Forms 1099–MISC.

(xxviii) Type of REIT.

(xxix) From Form 1125–A—purchases.

(xxx) From Form 1040, Schedule C—

(A) Purchases less cost of items withdrawn for personal use; and

(B) Materials and supplies.

(xxxi) Electronic filing system indicator.

(xxxii) Posting cycle date relative to filing.

(xxxiii) Dividends, including ordinary or qualified.

(xxxiv) From Form 1120S, Schedule K–1—ordinary business income (loss).

(xxxv) From Form 1065, Schedule K–1—

(A) Publicly-traded partnership indicator;

(B) Partner's share of nonrecourse, qualified nonrecourse, and recourse liabilities; and

(C) Ordinary business income (loss).

(b)(4) through (b)(6)(i)(B) [Reserved]. For further guidance see § 301.6103(j)(1)–1(b)(4) through (b)(6)(i)(B).

(C) From Form 1120–REIT—

(*1*) Type of REIT; and

(*2*) Gross rents from real property;

(D) From Form 1120F—corporation's method of accounting.

(E) From Form 1096—total amount reported.

(b)(6)(ii) through (d)(3)(ii) [Reserved]. For further guidance see § 301.6103(j)(1)–1(b)(6)(ii) through (d)(3)(ii).

(e) *Applicability date*. This section applies to disclosures to the Bureau of the Census made on or after December 9, 2016.

(f) *Expiration date*. The applicability of this section expires on or before December 9, 2019.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 23, 2016.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 8, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 9, 2016, 81 F.R. 89004)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 1288, 7520, 7872.)

Rev. Rul. 2017–02

This revenue ruling provides various prescribed rates for federal income tax purposes for January 2017 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. However, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the deemed rate of return for transfers made during calendar year 2017 to pooled income funds described in section 642(c)(5) that have been in existence for less than 3 taxable years immediately preceding the taxable year in which the transfer was made.

REV. RUL. 2017–02 TABLE 1

Applicable Federal Rates (AFR) for January 2017

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
		Short-term		
AFR	.96%	.96%	.96%	.96%
110% AFR	1.06%	1.06%	1.06%	1.06%
120% AFR	1.15%	1.15%	1.15%	1.15%

REV. RUL. 2017–02 TABLE 1

Applicable Federal Rates (AFR) for January 2017

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
130% AFR	1.25%	1.25%	1.25%	1.25%
		Mid-term		
AFR	1.97%	1.96%	1.96%	1.95%
110% AFR	2.17%	2.16%	2.15%	2.15%
120% AFR	2.36%	2.35%	2.34%	2.34%
130% AFR	2.57%	2.55%	2.54%	2.54%
150% AFR	2.96%	2.94%	2.93%	2.92%
175% AFR	3.46%	3.43%	3.42%	3.41%
		Long-term		
AFR	2.75%	2.73%	2.72%	2.71%
110% AFR	3.02%	3.00%	2.99%	2.98%
120% AFR	3.31%	3.28%	3.27%	3.26%
130% AFR	3.58%	3.55%	3.53%	3.52%

REV. RUL. 2017–02 TABLE 2

Adjusted AFR for January 2017

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	.71%	.71%	.71%	.71%
Mid-term adjusted AFR	1.47%	1.46%	1.46%	1.46%
Long-term adjusted AFR	2.04%	2.03%	2.02%	2.02%

REV. RUL. 2017–02 TABLE 3

Rates Under Section 382 for January 2017

Adjusted federal long-term rate for the current month	2.04%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	2.04%

REV. RUL. 2017–02 TABLE 4

Appropriate Percentages Under Section 42(b)(1) for January 2017

Note: Under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%.

Appropriate percentage for the 70% present value low-income housing credit	7.54%
Appropriate percentage for the 30% present value low-income housing credit	3.23%

REV. RUL. 2017–02 TABLE 5	
Rate Under Section 7520 for January 2017	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	2.4%

REV. RUL. 2017–02 TABLE 6	
Deemed Rate for Transfers to New Pooled Income Funds During 2017	
Deemed rate of return for transfers during 2017 to pooled income funds that have been in existence for less than 3 taxable years	1.2%

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2017. See Rev. Rul. 2017–2, page 364.

Part III. Administrative, Procedural, and Miscellaneous

Eligibility for Exemption from User Fee Requirement for Employee Plans Determination Letter Applications Filed On or After January 1, 2017

Notice 2017–01

I. Purpose

Section 7528(b)(2)(B) of the Internal Revenue Code provides an exemption from the requirement to pay a user fee for certain requests to the Internal Revenue Service (IRS) for determination letters with respect to the qualified status of pension, profit-sharing, stock bonus, annuity, and employee stock ownership (ESOP) plans maintained by small employers. Under § 7528(b)(2)(B), the exemption from the user fee does not apply to any request made after the later of (i) the fifth plan year of the plan's existence or (ii) the end of any remedial amendment period with respect to the plan beginning within the first five plan years (a "qualifying open remedial amendment period"). Section 7528(b)(2)(A) also permits the Secretary of the Treasury to provide exemptions from the user fee requirement. This notice describes the circumstances under which, in light of changes to the remedial amendment period rules set forth in Rev. Proc. 2016–37, 2016–29 I.R.B. 136, the IRS will treat an application for a determination letter as being filed within a qualifying open remedial amendment period (one of the requirements for the user fee exemption). Specifically, this notice provides that the IRS will treat an application for a determination letter as being filed within a qualifying open remedial amendment period if the plan was first in existence no earlier than January 1 of the tenth calendar year preceding the year in which the application is filed ("the ten-year rule").

This notice also provides that an application that satisfies the requirements for the user fee exemption in § 7528(b)(2)(B), but that does not meet the requirements for the ten-year rule described in the preceding paragraph, may be filed without a user fee. However, the application must include a statement describing how the application satisfies the exemption under § 7528(b)(2)(B).

II. Background

Section 7528(a)(1) provides the general rule that the Secretary of the Treasury is to establish a program requiring the payment of user fees for requests to the IRS for determination letters. The IRS user fee program procedures for requests involving employee plans and exempt organizations are published as part of the annual revenue procedures issued by the IRS. See, for example, Rev. Proc. 2016–8, 2016–1 I.R.B. 243.

Section 7528(b)(2)(A) provides that the Secretary shall provide for such exemptions from the user fee requirement (and reduced fees) as the Secretary determines to be appropriate.

Section 7528(b)(2)(B) provides that, in general, a request for a determination letter with respect to the qualified status of a pension benefit plan or any trust that is part of the plan shall be exempt from the user fee requirement if the plan is maintained solely by one or more eligible employers. Under § 7528(b)(2)(C)(i), a pension benefit plan means a pension, profit-sharing, stock bonus, annuity, or ESOP plan. Under § 7528(b)(2)(C)(ii), an eligible employer means an employer that has no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year, and that has at least one employee who is not a highly compensated employee (as defined in § 414(q)) and is participating in the plan. However, the § 7528(b)(2)(B) user fee exemption does not apply if the request is made after the later of (1) the last day of the fifth plan year the plan is in existence, or (2) the end of any qualifying open remedial amendment period. The § 7528(b)(2)(B) user fee exemption also does not apply to any request made by the sponsor of any prototype or similar plan that the sponsor intends to market to participating employers.

Rev. Proc. 2007–44, 2007–2 C.B. 54, provides for a system of cyclical remedial amendment periods and staggered submission periods for determination letter applications for individually designed plans and pre-approved plans. Under Rev. Proc. 2007–44, the remedial amendment cycle for individually designed plans is five years and the remedial amendment cycle for pre-approved plans is six years.

Rev. Proc. 2016–37 eliminates the remedial amendment cycle system for individually designed plans set forth in Rev. Proc. 2007–44, as of January 1, 2017. The revenue procedure provides that sponsors of Cycle A plans may continue to file under the remedial amendment cycle system until January 31, 2017. In addition, the revenue procedure makes clarifying changes to the ongoing six-year remedial amendment cycle system for pre-approved qualified plans. It also provides that the deadline for certain employers to adopt a newly approved pre-approved defined contribution plan that was based on the 2010 Cumulative List, and to apply for a determination letter, is extended from April 30, 2016, to April 30, 2017, for any newly approved pre-approved defined contribution plan adopted on or after January 1, 2016.

Notice 2002–1, 2002–1 C.B. 283, as amplified by Notice 2003–49, 2003–2 C.B. 294, provides guidance with respect to the requirements for the § 7528(b)(2)(B) user fee exemption, including an explanation of when a plan is "in existence" for that purpose (see Q&A–4 of Notice 2002–1). In addition, Notice 2011–86, 2011–45 I.R.B. 698, amplifies Notice 2002–1 by providing rules for determining, under the remedial amendment cycle system, if an application for a determination letter has been filed within a qualifying open remedial amendment period.

III. Applications Treated as Being Filed Within a Qualifying Open Remedial Amendment Period

An application for a determination letter with respect to a pension, profit-sharing, stock bonus, annuity, or ESOP plan maintained by an eligible employer that is filed with the IRS by the later of (1) the last day of the fifth plan year the plan is in existence, or (2) the end of any qualifying open remedial amendment period, will be eligible for the user fee exemption under § 7528(b)(2)(B), provided that the application satisfies all other applicable requirements for the exemption.

In order to simplify the process for establishing whether the user fee exemption under § 7528(b)(2) is available and, thus, whether a user fee is required to be paid with a determination letter application for a plan, the IRS will, pursuant to the authority under § 7528(b)(2)(A), treat an application as being filed within a qualifying open remedial amendment period (one of the requirements for the user fee exemption) if the plan was first in existence no earlier than January 1 of the tenth calendar year preceding the year in which the application is filed. For example, if an application for a determination letter for a plan that was first in existence during 2007 is filed on December 1, 2017, then the IRS will treat the application as having been filed within a qualifying open remedial amendment period for purposes of § 7528(b)(2). In contrast, if the plan in this example had first been in existence during 2006, then the IRS would not treat the application as being filed within a qualifying open remedial amendment period.

If an application does not satisfy the requirements of the ten-year rule described in the preceding paragraph (and, accordingly, is not treated under that rule as being filed within a qualifying open remedial amendment period), but the application nevertheless satisfies the requirements for the user fee exemption under § 7528(b)(2)(B) (for example, in a case in which a qualifying open remedial amendment period ends more than ten years after the year in which the plan is first in existence), then no user fee is required. In such a case, in lieu of including a user fee with the application, the applicant should explain in a cover letter how the application satisfies the requirements for the exemption under § 7528(b)(2)(B). If the IRS determines that the application does not meet the requirements for the user fee exemption under § 7528(b)(2)(B), the applicant will be asked to submit the required user fee.

IV. Effect on Other Documents

Notice 2002–1 is amplified.
Notice 2011–86 is obsoleted.

V. Effective Date

This notice generally applies to all applications for determination letters that are filed on or after January 1, 2017. However, the rules under Notice 2011–86 continue to apply to (1) an application for a determination letter that is filed on or before January 31, 2017, under Cycle A with respect to an individually designed plan; and (2) an application for a determination letter that is filed on or before April 30, 2017, with respect to a newly approved pre-approved defined contribution plan that is based on the 2010 Cumulative List and adopted on or after January 1, 2016.

VI. DRAFTING INFORMATION

The principal author of this notice is Patrick T. Gutierrez of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Mr. Gutierrez at (202) 317-4148 (not a toll-free number).

Maximum Vehicle Values for 2017 for Use With Vehicle Cents-Per-Mile and Fleet-Average Valuation Rules

Notice 2017–03

PURPOSE

This notice provides the maximum vehicle values for 2017 that taxpayers need to determine the value of personal use of employer-provided vehicles under the special valuation rules provided under section 1.61–21 (d) and (e) of the Income Tax Regulations.

MAXIMUM VEHICLE VALUES

The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2017 for which the vehicle cents-per-mile valuation rule provided under Regulation section 1.61–21(e) may be applicable is $15,900 for a passenger automobile and $17,800 for a truck or van.

The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2017 for which the fleet-average valuation rule provided under Regulation section 1.61–21(d) may be applicable is $21,100 for a passenger automobile and $23,300 for a truck or van.

EFFECTIVE DATE

This notice applies to employer-provided passenger automobiles first made available to employees for personal use in calendar year 2017.

DRAFTING INFORMATION

The principal author of this notice is Kathleen Edmondson of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information on this notice contact Ms. Edmondson on (202) 317-6798 (not a toll-free number).

Part IV. Items of General Interest

Recognition and Deferral of Section 987 Gain or Loss

REG–128276–12

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: Published elsewhere in this issue of the **Bulletin**, the Treasury Department and the IRS are issuing temporary regulations under section 987 of the Code relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a qualified business unit (QBU) in connection with certain QBU terminations and certain other transactions involving partnerships. The temporary regulations also contain rules providing: an annual deemed termination election for a section 987 QBU; an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; rules regarding the treatment of section 988 transactions of a section 987 QBU; rules regarding QBUs with the U.S. dollar as their functional currency; rules regarding combinations and separations of section 987 QBUs; rules regarding the translation of income used to pay creditable foreign income taxes; and rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987. Finally, the temporary regulations contain rules under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans. The text of the temporary regulations serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by March 8, 2017.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–128276–12), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–128276–12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–128276–12).

FOR FURTHER INFORMATION CONTACT:Concerning the proposed regulations, Steven D. Jensen at (202) 317-6938; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by February 6, 2017. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in: (1) §§ 1.987–1(b)(6)(iii)(A) and 1.987–1(g)(3)(i)(E); (2) §§ 1.987–3(b)(4)(iii)(C) and 1.987–1(g)(3)(i)(F); (3) §§ 1.987–3(d) and 1.987–1(g)(3)(i)(G); and (4) §§ 1.987–8(d) and 1.987–1(g)(3)(i)(H). Sections 1.987–1(b)(6)(iii)(A) and 1.987–1(g)(3)(i)(E) allow a controlled foreign corporation to elect to apply section 987 and the regulations thereunder (with certain exceptions) to a dollar QBU. Sections 1.987–3(b)(4)(iii)(C) and 1.987–1(g)(3)(i)(F) allow a taxpayer to elect to apply a foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions. Sections 1.987–3(d) and 1.987–1(g)(3)(i)(G) allow a taxpayer to elect to translate all items of income, gain, deduction, and loss of the section 987 QBU at the yearly average exchange rate. Sections 1.987–8(d) and 1.987–1(g)(3)(i)(H) allow a taxpayer to elect to deem all of its section 987 QBUs to terminate on the last day of each taxable year. The preceding elections are to be made pursuant to § 1.987–1(g). The collection of information is voluntary to obtain a benefit. The likely respondents are business or other for-profit institutions.

Estimated total annual reporting burden: 1,000 hours.

Estimated average annual burden hours per respondent: 1 hour.

Estimated number of respondents: 1,000.

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background and Explanation of Provisions

The temporary regulations (published in the Rules and Regulations section of this issue of the **Bulletin)** contain rules relating to the recognition and deferral of section 987 gain or loss with respect to a QBU. The temporary regulations also contain rules regarding an annual deemed termination election, an elective method for translating taxable income or loss with respect to a QBU, section 988 transactions of a section 987 QBU, QBUs with the U.S. dollar as their functional currency, combinations and separations of section 987 QBUs, translation of income used to pay creditable foreign income taxes, the allocation of assets and liabilities of certain partnerships for purposes of section 987, and the deferral of section 988 loss with respect to certain related-party loans. The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains those regulations and these proposed regulations.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Accordingly, a regulatory flexibility analysis is not required. This certification is based on the fact that these regulations will primarily affect U.S. corporations that have foreign operations, which tend to be larger businesses. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. In addition, the Treasury Department and the IRS request comments on the application of section 987 to entities and QBUs described in § 1.987–1(b)(1)(ii) to which the final regulations are not applicable (excluded entities and QBUs). Comments are requested on whether the Treasury Department and the IRS should issue regulations applying the foreign exchange exposure pool methodology described in §§ 1.987–3 and –4 to excluded entities and QBUs. Comments are also requested on the modifications, if any, that should be made to the foreign exchange exposure pool methodology adopted in the final regulations with respect to excluded entities and QBUs. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Mark E. Erwin of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1, as amended elsewhere in this issue of the Federal Register, is proposed to be further amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 985, 987, 989(c) and 7805 * * *

Par. 2. Section 1.987–1 is amended by adding paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(B) and (C), and (g)(3)(i)(E) through (H) to read as follows:

§ 1.987–1 Scope, definitions, and special rules.

* * * * *

(b) * * *

(1) * * *

(iii) [The text of the proposed amendment to § 1.987–1(b)(1)(iii) is the same as the text of § 1.987–1T(b)(1)(iii) published elsewhere in this issue of the **Bulletin**].

* * * * *

(6) [The text of the proposed amendment to § 1.987–1(b)(6) is the same as the text of § 1.987–1T(b)(6) published elsewhere in this issue of the **Bulletin**].

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(B) [The text of the proposed amendment to § 1.987–1(c)(1)(ii)(B) is the same as the text of § 1.987–1T(c)(1)(ii)(B) published elsewhere in this issue of the **Bulletin**].

* * * * *

(c) * * *

(3) * * *

(i) * * *

(E) [The text of the proposed amendment to § 1.987–1(c)(3)(i)(E) is the same as the text of § 1.987–1T(c)(3)(i)(E) published elsewhere in this issue of the **Bulletin**].

* * * * *

(d) * * *

(3) [The text of the proposed amendment to § 1.987–1(d)(3) is the same as the text of § 1.987–1T(d)(3) published elsewhere in this issue of the **Bulletin**].

* * * * *

(f) [The text of the proposed amendment to § 1.987–1(f) is the same as the text of § 1.987–1T(f) published elsewhere in this issue of the **Bulletin**].

* * * * *

(g) * * *

(2) * * *

(i) * * *

(B) [The text of the proposed amendment to § 1.987–1(g)(2)(i)(B) is the same as the text of § 1.987–1T(g)(2)(i)(B) published elsewhere in this issue of the **Bulletin**].

(C) [The text of the proposed amendment to § 1.987–1(g)(2)(i)(C) is the same as the text of § 1.987–1T(g)(2)(i)(C) published elsewhere in this issue of the **Bulletin**].

* * * * *

(3) * * *

(i) * * *

(E) [The text of the proposed amendment to § 1.987–1(g)(3)(i)(E) is the same as the text of § 1.987–1T(g)(3)(i)(E) published elsewhere in this issue of the **Bulletin**].

(F) [The text of the proposed amendment to § 1.987–1(g)(3)(i)(F) is the same as the text of § 1.987–1T(g)(3)(i)(F) published elsewhere in this issue of the **Bulletin**].

(G) [The text of the proposed amendment to § 1.987–1(g)(3)(i)(G) is the same as the text of § 1.987–1T(g)(3)(i)(G) published elsewhere in this issue of the **Bulletin**].

(H) [The text of the proposed amendment to § 1.987–1(g)(3)(i)(H) is the same as the text of § 1.987–1T(g)(3)(i)(H) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 3. Section 1.987–2 is amended by adding paragraph (c)(9) to read as follows:

§ 1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

* * * * *

(c) * * *

(9) [The text of the proposed amendment to § 1.987–2(c)(9) is the same as the text of § 1.987–2T(c)(9) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 4. Section 1.987–3 is amended by adding paragraphs (b)(2)(ii), (b)(4), (c)(2)(ii) and (v), (d), and *Example 9* through *Example 14* of paragraph (e) to read as follows:

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

* * * * *

(b) * * *

(2) * * *

(ii) [The text of the proposed amendment to § 1.987–3(b)(2)(ii) is the same as the text of § 1.987–3T(b)(2)(ii) published elsewhere in this issue of the **Bulletin**].

* * * * *

(4) [The text of the proposed amendment to § 1.987–3(b)(4) is the same as the text of § 1.987–3T(b)(4) published elsewhere in this issue of the **Bulletin**].

* * * * *

(c) * * *

(2) * * *

(ii) [The text of the proposed amendment to § 1.987–3(c)(2)(ii) is the same as the text of § 1.987–3T(c)(2)(ii) published elsewhere in this issue of the **Bulletin**].

* * * * *

(v) [The text of the proposed amendment to § 1.987–3(c)(2)(v) is the same as the text of § 1.987–3T(c)(2)(v) published elsewhere in this issue of the **Bulletin**].

(d) [The text of the proposed amendment to § 1.987–3(d) is the same as the text of § 1.987–3T(d) published elsewhere in this issue of the **Bulletin**].

(e) *Examples*. * * *

Example 9 [The text of the proposed amendment to § 1.987–3(e) *Example 9* is the same as the text of § 1.987–3T(e) *Example 9* published elsewhere in this issue of the **Bulletin**].

Example 10 [The text of the proposed amendment to § 1.987–3(e) *Example 10* is the same as the text of § 1.987–3T(e) *Example 10* published elsewhere in this issue of the **Bulletin**].

Example 11 [The text of the proposed amendment to § 1.987–3(e) *Example 11* is the same as the text of § 1.987–3T(e) *Example 11* published elsewhere in this issue of the **Bulletin**].

Example 12 [The text of the proposed amendment to § 1.987–3(e) *Example 12* is the same as the text of § 1.987–3T(e) *Example 12* published elsewhere in this issue of the **Bulletin**].

Example 13 [The text of the proposed amendment to § 1.987–3(e) *Example 13* is the same as the text of § 1.987–3T(e) *Example 13* published elsewhere in this issue of the **Bulletin**].

Example 14 [The text of the proposed amendment to § 1.987–3(e) *Example 14* is the same as the text of § 1.987–3T(e) *Example 14* published elsewhere in this issue of the **Bulletin**].

Par. 5. Section 1.987–4 is amended by adding paragraphs (c)(2) and (f) to read as follows:

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

* * * * *

(c) * * *

(2) [The text of the proposed amendment to § 1.987–4(c)(2) is the same as the text of § 1.987–4T(c)(2) published elsewhere in this issue of the **Bulletin**].

* * * * *

(f) [The text of the proposed amendment to § 1.987–4(f) is the same as the text of § 1.987–4T(f) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 6. Section 1.987–6 is amended by adding paragraph (b)(4) to read as follows:

§ 1.987–6 Character and source of section 987 gain or loss.

* * * * *

(b) * * *

(4) [The text of the proposed amendment to § 1.987–6(b)(4) is the same as the text of § 1.987–6T(b)(4) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 7. Section 1.987–7 is amended by adding paragraph (b) to read as follows:

§ 1.987–7 Section 987 aggregate partnerships.

* * * * *

(b) [The text of the proposed amendment to § 1.987–7(b) is the same as the text of § 1.987–7T(b) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 8. Section 1.987–8 is amended by adding paragraph (d) to read as follows:

§ 1.987–8 Termination of a section 987 QBU.

* * * * *

(d) [The text of the proposed amendment to § 1.987–8(d) is the same as the text of § 1.987–8T(d) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 9. Section 1.987–12 is revised to read as follows:

§ 1.987–12 Deferral of section 987 gain or loss.

[The text of the proposed amendment to § 1.987–12 is the same as the text of § 1.987–12T published elsewhere in this issue of the **Bulletin**].

Par. 10. Section 1.988–1 is amended by adding paragraph (a)(3) to read as follows:

§ 1.988–1 Certain definitions and special rules.

* * * * *

(a) * * *

(3) [The text of the proposed amendment to § 1.988–1(a)(3) is the same as the text of § 1.988–1T(a)(3) published elsewhere in this issue of the **Bulletin**].

* * * * *

Par. 11. Section 1.988–2 is amended by revising paragraph (b)(16) and adding paragraph (i) to read as follows:

§ 1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(16) [The text of the proposed amendment to § 1.988–2(b)(16) is the same as the text of § 1.988–2T(b)(16) published elsewhere in this issue of the **Bulletin**].

* * * * *

(i) [The text of the proposed amendment to § 1.988–2(i) is the same as the text of § 1.988–2T(i) published elsewhere in this issue of the **Bulletin**].

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 7, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 8, 2016, 81 F.R. 88882)

Disclosures of Return Information Reflected on Returns to Officers and Employees of the Department of Commerce for Certain Statistical Purposes and Related Activities

REG–133353–16

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulation.

SUMMARY: In the Rules and Regulations section of this issue of the **Bulletin** the IRS is issuing temporary regulations authorizing the disclosure of specified return information to the Bureau of the Census (Bureau) for purposes of structuring the censuses and national economic accounts and conducting related statistical activities authorized by title 13. The temporary regulations are made pursuant to a request from the Secretary of Commerce. The temporary regulations also provide clarifying language for an item of return information and remove duplicative paragraphs contained in the existing final regulations. These regulations require no action by taxpayers and have no effect on their tax liabilities. Thus, no taxpayers are likely to be affected by the disclosures authorized by this guidance. The text of the temporary regulations published in the Rules and Regulations section of the **Federal Register** serves as the text of these proposed regulations.

DATES: Written and electronic comments and requests for a public hearing must be received by March 9, 2017.

Applicability Date: For dates of applicability, see § 301.6103(j)(1)–1(e).

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–133353–16), room 5203, Internal Revenue Service, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–133353–16), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–133353–16).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, William Rowe, (202) 317-6834; concerning submissions of comments, Regina Johnson, (202) 317-5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains proposed amendments to 26 CFR part 301 relating to section 6103(j)(1)(A) of the Internal Revenue Code (Code). Section 6103 (j)(1)(A) authorizes the Secretary of the Treasury to furnish, upon written request by the Secretary of Commerce, such returns or return information as the Secretary of Treasury may prescribe by regulation to officers and employees of the Bureau for the purpose of, but only to the extent necessary in, the structuring of censuses and national economic accounts and conducting related statistical activities authorized by law. Section 301.6103(j)(1)–1 of the regulations further defines such purposes by reference to 13 U.S.C. chapter 5 and provides an itemized description of the return information authorized to be disclosed for such purposes. This document contains proposed regulations authorizing the disclosure of additional items of return information requested by the Secretary of Commerce. These proposed regulations also provide clarifying language for an item of return information and remove duplicative paragraphs contained in the existing regulations. Temporary regulations in the Rules and Regulations section of this issue of the **Bulletin** amend 26 CFR part 301. The text of those temporary regulations serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities because the regulations do not impose a collection of information on small entities. Accordingly, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The IRS and Treasury Department request comments on all aspects of the proposed regulations. All comments that are submitted will be available for public inspection and copying at *www.regulations.gov* or upon request. A public hearing may be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is William Rowe, Office of the Associate Chief Counsel (Procedure & Administration).

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 301.6103(j)(1)–1 is amended by adding paragraphs (b)(2)(iii)(K) through (M), (b)(3)(xxxi) through (xxxv), and (b)(6)(i)(C) through (E), and revising paragraphs (b)(2)(iii)(I), (b)(3)(v), (b)(3)(xxv) through (xxx), and (e) to read as follows:

§ 301.6103(j)(1)–1 Disclosures of return information reflected on returns to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

* * * * *

(b) * * *

(2) * * *

(iii) * * *

(I) [The text of proposed amendments to § 301.6103(j)(1)–1(b)(2)(iii)(I) is the same as the text of § 301.6103(j)(1)–1T(b)(2)(iii)(I) published elsewhere in this issue of the **Bulletin**].

* * * * *

(K) through (M) [The text of proposed amendments to § 301.6103(j)(1)–1(b)(2)(iii)(K) through (M) is the same as the text of § 301.6103(j)(1)–1T(b)(2)(iii)(K) through (M) published elsewhere in this issue of the **Bulletin**].

* * * * *

(3) * * *

(v) [The text of proposed amendments to § 301.6103(j)(1)–1(b)(3)(v) is the same as the text of § 301.6103(j)(1)–1T(b)(3)(v) published elsewhere in this issue of the **Bulletin**].

* * * * *

(xxv) through (xxxv) [The text of proposed amendments to § 301.6103(j)(1)–1(b)(3)(xxv) through (xxxv) is the same as the text of § 301.6103(j)(1)–1T(b)(3)(xxv) through (xxxv) published elsewhere in this issue of the **Bulletin**].

* * * * *

(6) * * *

(i) * * *

(C) through (E) [The text of proposed amendments to § 301.6103(j)(1)–1T(b)(6)(i)(C) through (E) is the same as the text of § 301.6103(j)(1)–1T(b)(6)(i)(C) through (E) published elsewhere in this issue of the **Bulletin**].

* * * * *

(e) *Applicability date*. Paragraphs (b)(2)(iii)(I), (b)(2)(iii)(K) through (M), (b)(3)(v), (b)(3)(xxv) through (xxxv), and (b)(6)(i)(C) through (E) of this section apply to disclosure of the Bureau of the Census made on or after December 9, 2016. For rules that apply to disclosure to the Bureau of the Census before that date, see 26 CFR 301.6103(j)(1)–1 (revised as of April 1, 2016).

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 8, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 9, 2016, 81 F.R. 89022)

Health Insurance Providers Fee

REG–134438–15

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would modify the current definition of "net premiums written" for purposes of the fee imposed by section 9010 of the Patient Protection and Affordable Care Act, as amended. The proposed regulations will affect persons engaged in the business of providing health insurance for United States health risks.

DATES: Comments and requests for a public hearing must be received by March 9, 2017.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–134438–15), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–134438–15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically, via the Federal eRulemaking portal at www.regulations.gov (IRS REG–134438–15)

FOR FURTHER INFORMATION CONTACT:Concerning the proposed regulations, Rachel S. Smith, (202) 317-6855; concerning submissions of comments and request for a hearing, Regina Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 9010 of the Patient Protection and Affordable Care Act (PPACA), Public Law No. 111–148 (124 Stat. 119 (2010)), as amended by section 10905 of PPACA, and as further amended by section 1406 of the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)) (collectively, the Affordable Care Act or ACA) imposes an annual fee on covered entities that provide health insurance for United States health risks. Section 9010 did not amend the Internal Revenue Code (Code) but contains cross-references to specified Code sections. In this preamble all references to section 9010 are references to section 9010 of the ACA and all references to ''fee'' are references to the fee imposed by section 9010.

Section 9010(a) imposes an annual fee on each covered entity engaged in the business of providing health insurance. The fee is due by the annual date specified by the Secretary, but in no event later than September 30th of each calendar year in which a fee must be paid (fee year).

Section 9010(b) requires the Secretary to determine the annual fee for each covered entity based on the ratio of the covered entity's net premiums written for health insurance for any United States health risk that are taken into account for the calendar year immediately before the fee year (data year) to the aggregate net premiums written for health insurance of United States health risks of all covered entities that are taken into account during the data year. In calculating the fee, the Secretary must determine each covered entity's net premiums written for United States health risks based on reports submitted to the Secretary by the covered entity and through the use of any other source of information available to the Secretary. Section 9010 does not define the term "net premiums written."

On November 29, 2013, the Treasury Department and the IRS published in the **Federal Register** (TD 9643; 78 FR 71476) final regulations regarding the fee (final regulations). The final regulations define *net premiums written* to mean premiums written, including reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions and medical loss ratio (MLR) rebates with respect to the data year. Net premiums written do not include premiums written for indemnity reinsurance (and are not reduced by indemnity reinsurance ceded) because indemnity reinsurance is not considered health insurance for purposes of section 9010. However, net premiums written do include premiums written (and are reduced by premiums ceded) for assumption reinsurance; that is, reinsurance for which there is a novation and the reinsurer takes over the entire risk.

The preamble to the final regulations explained that, for covered entities that file the Supplemental Health Care Exhibit (SHCE) with the National Association of Insurance Commissioners (NAIC), net premiums written for health insurance generally will equal the amount reported on the SHCE as direct premiums written minus MLR rebates with respect to the data year, subject to any applicable exclusions under section 9010. The instructions to Form 8963, *Report of Health Insurance Provider Information*, provide additional information on how to determine net premiums written using the SHCE and any equivalent forms as the source of data, and can be updated to reflect changes to the SHCE.

Explanation of Provisions

The proposed regulations would amend and clarify the rules for how "net premiums written" take into account certain premium adjustments and payments.

1. *Retrospective Premium Adjustments*

Following the publication of the final regulations, the Treasury Department and the IRS received comments requesting that premium adjustments related to retrospectively rated contracts be taken into account in determining net premiums written. The NAIC's Accounting Practices and Procedures Manual Statement of Statutory Accounting Principles No. 66, *Retrospectively Rated Contracts*, defines a retrospectively rated contract as a contract which has the final policy premium calculated based on the loss experience of the insured during the term of the policy (including loss development after the term of the policy) and on the stipulated formula set forth in the policy or a formula required by law. These premium adjustments, made periodically, may involve either the payment of return premium to the insured (a "retrospectively rated contract payment") or payment of an additional premium by the insured (a "retrospectively rated contract receipt"), or both, depending on experience.

Commenters recommended that in calculating net premiums written, premiums written should be increased by retrospectively rated contract receipts and reduced by retrospectively rated contract payments. Commenters asserted that retrospectively rated contract payments are refunded to policyholders in much the same way as MLR rebates. Therefore, without an adjustment for retrospectively rated contract payments, covered entities that make these payments will bear a liability for an amount of the annual fee that correlates to premiums from which they do not actually receive an economic benefit.

In response to these comments, the proposed regulations would modify the current definition of net premiums written to account for premium adjustments related to retrospectively rated contracts, computed on an accrual basis. These amounts are received from and paid to policyholders annually based on experience. Retrospectively rated contract receipts and payments do not include changes to funds or accounts that remain under the control of the covered entity, such as changes to premium stabilization reserves.

2. *Risk Adjustment Payments and Charges*

Following the publication of the final regulations, questions also arose about the treatment of risk adjustment payments under the ACA. Section 1343 of the ACA provides a permanent risk adjustment program for certain plans in the individual and small group markets. In general, the program transfers risk adjustment funds from health insurance plans with relatively lower-risk enrollees to issuers that disproportionately attract high-risk populations, such as individuals with chronic conditions. Section 1343(a)(1) generally requires each state, or the Department of Health and Human Services (HHS) acting on behalf of the state, to assess a charge on health plans and health insurance issuers in the individual or small group markets within a state (with respect to health insurance coverage) if the actuarial risk of the enrollees of such plans or coverage for a year is less than the average actuarial risk of all enrollees in all plans or coverage in the state for the year that are not self-insured group health plans. Section 1343(a)(2) generally requires each state, or HHS acting on behalf of the state, to make a payment to health plans and health insurance issuers in the individual or small group markets within a state (with respect to health insurance coverage) if the actuarial risk of the enrollees of such plans or coverage for a year is greater than the average actuarial risk of all enrollees in all plans and coverage in the state for the year that are not self-insured group health plans.

Although not specifically listed, net premiums written, as defined in the final regulations, include risk adjustment payments received by a covered entity under section 1343(a)(2) of the ACA and are reduced for risk adjustment charges paid by a covered entity under section 1343(a)(1) of the ACA. Nonetheless, several covered entities asked whether net premiums written included risk adjustment payments received and charges paid. Therefore, these proposed regulations add specific language to the definition of net premiums written to clarify that net premiums written include risk adjustment payments received and are reduced for risk adjustment charges paid. If a covered entity did not include risk adjustment payments received as direct premiums written on its SHCE or did not file an SHCE, these amounts are still part of net premiums written and must be reported as such on Form 8963. For this purpose, risk adjustment payments received and charges paid are computed on an accrual basis.

3. *Other Premium Adjustments*

These proposed regulations would authorize the IRS to provide rules in guidance published in the Internal Revenue Bulletin for additional amounts to be taken into account in determining net premiums written. If the Treasury Department and the IRS determine that published guidance providing additional adjustments to net premiums written is warranted, such guidance will be published in the Internal Revenue Bulletin.

Proposed Effective/Applicability Date

These regulations are proposed to apply with respect to any fee that is due on or after September 30, 2018.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. Because these regulations do not include a collection of information, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to Code section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of these proposed regulations. The Treasury Department and the IRS specifically request comments on the following:

1. How the adjustments to net premiums written under these proposed regulations tie to amounts reported on the SHCE.
2. Whether there should be a transition rule for premium adjustments related to retrospectively rated contracts and how any such rule should be implemented.

All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Rachel S. Smith, IRS Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 57 is proposed to be amended as follows:

PART 57—HEALTH INSURANCE PROVIDERS FEE

Paragraph 1. The authority citation for part 57 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Par. 2. Section 57.2 is amended by revising paragraph (k) to read as follows:

§ 57.2 Explanation of terms.

* * * * *

(k) *Net premiums written*—(1) *In general*. The term *net premiums written* means premiums written, adjusted as provided in paragraph (k)(2) of this section.

(2) *Adjustments*. Net premiums written include adjustments to account for:

(i) *Assumption reinsurance, but not indemnity reinsurance*. Net premiums written include reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions with respect to the data year. Net premiums written do not include premiums written for indemnity reinsurance and are not reduced by indemnity reinsurance ceded because indemnity reinsurance within the meaning of paragraph (h)(5)(i) of this section is not health insurance under paragraph (h)(1) of this section. However, in the case of assumption reinsurance within the meaning of paragraph (h)(5)(ii) of this section, net premiums written include premiums written for assumption reinsurance, reduced by assumption reinsurance premiums ceded.

(ii) *Medical loss ratio (MLR) rebates*. Net premiums written are reduced by MLR rebates with respect to the data year. For this purpose, MLR rebates are computed on an accrual basis.

(iii) *Premium adjustments related to retrospectively rated contracts*. Net premiums written include retrospectively rated contract receipts and are reduced by retrospectively rated contract payments with respect to the data year. For this purpose, net premium adjustments related to retrospectively rated contracts are computed on an accrual basis.

(iv) *Amounts related to the risk adjustment program under section 1343 of the ACA*. Net premiums written include risk adjustment payments (within the meaning of 42 U.S.C. 18063(b)) received with respect to the data year and are reduced by risk adjustment charges (within the meaning of 42 U.S.C. 18063(a)) paid with respect to the data year. For this purpose, risk adjustment payments and risk adjustment charges are computed on an accrual basis.

(v) *Additional adjustments published in the Internal Revenue Bulletin*. The IRS may provide rules in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) for additional adjustments against premiums written in determining net premiums written.

Par. 3. Section 57.10 is amended by revising paragraph (a) and adding paragraph (c) to read as follows:

§ 57.10 Effective/applicability date.

(a) *In general*. Except as provided in paragraphs (b) and (c) of this section, §§ 57.1 through 57.9 apply to any fee that is due on or after September 30, 2014.

* * * * *

(c) *Paragraph (k) of § 57.2*. Paragraph (k) of § 57.2 applies to any fee that is due on or after September 30, 2018.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 8, 2016, 8:45 a.m., and published in the issue of the Federal Register for December 9, 2016, 81 F.R. 89017)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with modified, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with amplified and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, modified and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2016–27 through 2016–52 is in Internal Revenue Bulletin 2016–52, dated December 26, 2016.

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