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Department of the Treasury

Internal Revenue Service

26 CFR Part 1

**Income and Currency Gain or Loss With
Respect to a Section 987 QBU; Proposed
Rule**

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1**

[REG-208270-86]

RIN 1545-AM12

Income and Currency Gain or Loss With Respect to a Section 987 QBU**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Withdrawal of notice of proposed rulemaking, notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance under section 987 of the Internal Revenue Code (Code) regarding the determination of the items of income or loss of a taxpayer with respect to a section 987 qualified business unit (section 987 QBU) as well as the timing, amount, character and source of any section 987 gain or loss. It withdraws proposed regulations under section 987 that were published in the **Federal Register** on September 25, 1991 (56 FR 48457). These regulations are necessary to provide guidance under section 987. Taxpayers affected by these regulations are corporations and individuals with qualified business units subject to section 987.

DATES: Written or electronic comments must be received by December 6, 2006. Outlines of topics to be discussed at the public hearing scheduled for November 21, 2006, must be received by October 31, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-208270-86), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be sent electronically, via the IRS Internet site at <http://www.irs.gov/reg> or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-208270-86).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sheila Ramaswamy at (202) 622-3870; concerning submissions of comments, Kelly Banks at (202) 622-7180 (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 Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 6, 2006.

Comments are requested specifically concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions 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 or 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 these proposed regulations is in §§ 1.987-1(b)(1)(ii), 1.987-1(b)(2)(ii), 1.987-1(c)(1)(ii), 1.987-1(f), 1.987-3(b)(1), 1.987-9, 1.987-10 and 1.987-11. Section 1.987-1(b)(1)(ii) allows a partner to make an election not to take section 987 gain or loss into account. Section 1.987-1(b)(2)(ii) allows a taxpayer to make an election to group certain QBUs with the same functional currency as a single QBU. Sections 1.987-1(c)(1)(ii) and -3(b)(1) allow a taxpayer to make an election to use a convention for exchange rates. Section 1.987-11(b) allows a taxpayer to elect to apply these regulations to taxable years beginning after the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. The preceding elections are to be made pursuant to § 1.987-1(f) by attaching a statement to the taxpayer's tax return describing the election to be made. Section 1.987-9 contains recordkeeping rules to establish a qualified business unit's income and section 987 gain or loss. This collection of information is required to establish the qualified business unit's income, gain, deduction or loss and assets and

liabilities as well as exchange rates used for foreign currency translation purposes. Section 1.987-10 provides rules for transitioning to the method provided under the new proposed regulations for determining section 987 gain or loss and provides certain corresponding reporting rules. The collection of information contained in this regulation facilitates the identification of the prior method used by the taxpayer to determine section 987 gain or loss. The collections of information are mandatory. The likely respondents are taxpayers with foreign qualified business units.

Estimated total annual reporting burden: 12,000.

Estimated average annual burden hours per respondent: 12.

Estimated number of respondents: 1,000.

Estimated annual frequency of responses: annually.

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*A. Overview*

As part of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085 (October 22, 1986), 1986-3 CB Vol.1, 1, see § 601.601(d)(2), Congress enacted comprehensive reforms to the tax treatment of foreign currency transactions by adding new subpart J. Those reforms included, among other things, the introduction of the functional currency concept, which generally distinguishes taxpayers on the basis of the primary currency in which they keep their books and records and conduct their business. Reforms also included the addition of the qualified business unit (QBU) concept, which generally provides a basis for allowing a taxpayer with a separate unit that conducts business and keeps books and records in a currency other than the functional currency of the taxpayer to account for the results of operation of the separate unit in the unit's own functional currency. Against that conceptual background, section 988 provides rules for the treatment of transactions in a currency other than the

taxpayer's functional currency. Section 986 generally provides rules for translating into U.S. dollars the earnings and profits and foreign taxes of a foreign corporation whose functional currency is not the U.S. dollar (dollar). Section 987, in turn, generally provides rules for determining and translating income and currency gain and loss with respect to operations of a branch whose functional currency is other than the functional currency of the taxpayer. As discussed below, an already complex area of law was made even more complicated when the entity classification rules under § 301.7701-1 through 301.7701-3 (the "check the box" regulations) were promulgated in 1997.

On September 25, 1991, the IRS and the Treasury Department issued proposed regulations under section 987 (the 1991 proposed regulations). See 56 FR 48457. In light of subsequent IRS experience with taxpayer claims of large non-economic currency losses under section 987, the IRS and the Treasury Department issued Notice 2000-20 (2000-1 CB 851). See § 601.601(d)(2). This notice expressed serious concern that the 1991 proposed regulations had not fully achieved the original goal of facilitating recognition of true economic foreign currency gain and loss under appropriate circumstances and requested comments on this issue and other matters.

This document withdraws the 1991 proposed regulations and provides new proposed regulations based on the "foreign exchange exposure pool" method. The IRS and the Treasury Department believe that this method more accurately reflects foreign currency gain and loss than the 1991 proposed regulations and does so in a manner consistent with statutory authority and legislative intent. These new proposed regulations are designed to prescribe more precisely foreign currency gain and loss that is economically realized, while minimizing or eliminating the realization of non-economic currency gain and loss.

The following background discussion describes section 987, its legislative history, the 1991 proposed regulations, Notice 2000-20, and the general approach that provides the basis for the foreign exchange exposure pool method.

B. The Statute

Section 987 generally provides that in the case of a taxpayer having a QBU with a functional currency other than that of the taxpayer, the taxable income of the taxpayer with respect to the QBU is determined by computing the taxable income or loss of the QBU separately

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 treating post-1986 remittances from each such unit as made on a pro rata basis out of post-1986 accumulated earnings; 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.

C. The Legislative History

1. Prior Law

As described in the applicable legislative history,¹ section 987 was enacted against a background of, and partly in reaction to, perceived shortcomings with prevailing law. The prevailing law at that time was fairly limited. It consisted primarily of two revenue rulings that provided alternative methods for calculating branch taxable income.

Rev. Rul. 75-106 (1975-1 CB 31), see § 601.601(d)(2), provides for the use of a "net worth" method. Under this method, taxable income of a branch of a domestic corporation engaged in business in a foreign country is defined generally as the difference between the branch's opening and closing net worth as reflected on the branch's balance sheets for the taxable year. Under this method, the branch's balance sheet is translated into U.S. dollars. In general, the values of current items (such as cash or cash flows denominated in foreign currency) are translated at the year-end exchange rate, and the values of historical items (such as equipment) are translated at the exchange rate for the period in which the item was acquired or incurred. The translation of an item at the year-end rate causes changes in the item's value due to currency fluctuations to be taken into account annually, and the translation of an item at the historical rate generally precludes recognition of fluctuations in value due to changing exchange rates. In this way, the net worth method was able to identify items considered economically exposed to fluctuations in exchange rates. The total change in net worth identified by the net worth method is equal to the sum of the operating profit or loss of the branch and the exchange

gain or loss on current items. However, the net worth method does not identify separate items of income and expense because it is based solely on a balance sheet comparison and does not use a profit and loss statement.

Rev. Rul. 75-107 (1975-1 CB 32), see § 601.601(d)(2), provides for the use of a "profit and loss" method. Under this method, the branch computes taxable income by translating the local currency profit and loss statement (adjusted for U.S. tax principles) into dollars. Any portion of the profit and loss remitted to the home office during the year is translated at the exchange rate on the date of the remittance, and the remainder is translated at the year-end exchange rate. No exchange gain or loss is recognized on a remittance.

The net worth method of Rev. Rul. 75-106 and the profit and loss method of Rev. Rul. 75-107 each suffered from infirmities. The net worth method resulted in the realization of foreign currency gain and loss that was not consistent with the general realization principles of the Code; it also failed to accurately characterize items of income, gain, deduction or loss of the branch. The profit and loss method, in turn, did not take into account foreign currency gain and loss inherent in the assets and liabilities on the balance sheet as part of such method. Both methods failed to account for foreign currency gain or loss in the event of a remittance.

The legislative history states that under section 987, a taxpayer with a QBU whose functional currency is other than the functional currency of the taxpayer will be required to use a profit and loss method, rather than the net worth method (as this method was understood at the time). House Report (1986-3 CB Vol. 2, 479); Senate Report (1986-3 CB Vol. 3, 470); and Conference Report (1986-3 CB Vol. 4, 675). See § 601.601(d)(2). However, this legislative history is not properly read as an explicit rejection of the net worth method in its entirety. Instead, it is more accurately viewed as a rejection of certain aspects of the law prevailing at that time. Importantly, the method provided in section 987 as enacted actually represents a blend of the separate methods, as it has aspects of both a net worth method and a profit and loss method. It also has at least one feature absent from each method—that is, section 987 includes the remittance recognition concept. Consistent with a profit and loss method, sections 987(1) and (2) generally determine the items of income or loss of a QBU based on its profit and loss statement as determined in its functional currency. Such items are then translated into the taxpayer's

¹ H. Rep. No. 99-426, 99th Cong., 1st Sess. (1985); 1986-3 CB Vol 2, 449. S. Rep. No 99-313, 99th Cong., 2d Sess. (1986); 1986-3 CB Vol. 3, 443. H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. (1986); 1986-3 CB Vol. 4, 659. Later citations are to the Cumulative Bulletin. See § 601.601(d)(2).

functional currency at the appropriate rate.² Consistent with a net worth method, section 987(3) requires that exchange gain or loss be computed with respect to certain branch assets and liabilities (as prescribed by the Secretary). Unlike either method, section 987(3)(A) provides that exchange gain or loss is recognized upon a remittance.

The blending of features of both a profit and loss method and of a net worth method in section 987 is significant. Together with more specific principles identified in the legislative history, this blending of methods informs the Congressionally stated preference for the profit and loss method. The House Report states:

A profit and loss method can be viewed as being more consistent with the functional currency concept than a net worth method. Under a profit and loss method, the functional currency is used as the measure of income or loss, so that earnings determined for U.S. tax purposes would bear a close relation to taxable income computed by the foreign jurisdiction. In contrast, a net worth method takes unrealized exchange gains and losses into account. Further, a profit and loss method minimizes the accounting procedures that otherwise would be required to make the item-by-item translations under a net worth method. Finally, in the case of a branch, the net worth method as applied under present law fails to characterize accurately items of income or loss that are subject to special U.S. tax rules. For example, although there are limitations on the deductibility of long-term capital losses, such a loss incurred by a branch would be given tax effect because it would be reflected as an adjustment to the balance sheet.

House Report at 469.

The House and Senate reports are generally uniform in describing Congressional intent with regard to the computations required under section 987 as illustrated by the Senate Report.

Under the bill, a taxpayer with a branch whose functional currency is a currency other than the U.S. dollar will be required to use the profit and loss method to compute branch income. Thus, the net worth method will no longer be an acceptable method of computing income or loss of a foreign branch for tax purposes, and only realized exchange gains and losses on branch capital will be reflected in taxable income.

For each taxable year, the taxpayer will compute income or loss separately for each qualified business unit in the business unit's functional currency, converting this amount to U.S. dollars using the weighted average exchange rate for the taxable period over which the income or loss accrued. This amount will be included in income without

reduction for remittances from the branch during the year. The committee anticipates that regulations will provide rules that will limit the deduction of branch losses to the taxpayer's dollar basis in the branch (that is, the original dollar investment plus subsequent capital contributions and unremitted earnings).

A taxpayer will recognize exchange gain or loss on remittances (without regard to whether or when the remittances are converted to dollars), to the extent the value of the currency at the time of the remittance differs from the value when earned. Remittances of foreign branch earnings (and interbranch transfers involving branches with different functional currencies) after 1986 will be treated as paid pro rata out of post-1986 accumulated earnings of the branch. The committee anticipates that, for purposes of calculating exchange gain or loss on remittances, the value of the currency will be determined by translating the currency at the rate in effect on the date of remittance. Exchange gains and losses on such remittances will be deemed to be ordinary and domestic source.

Senate Report (1986-3 CB Vol. 3, 470). Importantly, the Conference Report modifies the House and Senate reports by stating that a remittance by a QBU "will trigger exchange gain or loss inherent in accumulated earnings or branch capital." Conference Report, 1986-3 CB Vol. 4, 675.

From section 987 and the foregoing legislative history, several principles emerge:

1. A branch profit and loss computation is required in order to properly characterize items of branch income or loss, which is taken into account in the year earned.
2. Exchange gain or loss is recognized upon a remittance, in an amount prescribed by the Secretary.
3. Both branch earnings and branch capital can give rise to exchange gain or loss under section 987.
4. Regulations under section 987 should seek to minimize complexity regarding item-by-item translations.
5. The currency gain or loss taken into account under section 987 is only the economic gain or loss "inherent in" the assets and liabilities of a QBU.

2. Relationship Between Section 986(c) and 987

Comments to the IRS and the Treasury Department have suggested that the computation under section 987 of exchange gain or loss for a branch is intended to operate in the same manner as the computation under section 986(c) of certain exchange gain or loss of a foreign corporation. In general, section 986(c) provides for the recognition of exchange gain or loss only with respect to distributions of previously taxed earnings and profits (as described in section 959 or 1293(c)). The Conference Report includes the following general statement about the translation rules:

The same translation rule applies to the earnings and profits of a foreign corporation and the income or loss of a branch or other QBU. An entity that uses a nonfunctional currency to measure the results of operation is required to use a profit and loss method to translate income or loss into functional currency. * * * These translation rules apply without regard to the form of enterprise through which the taxpayer conducts business (e.g., sole proprietorship, partnership, or corporation) as long as such form of enterprise rises to the level of a QBU.

Conference Report, 1986-3 CB Vol. 4, 670. See § 601.601(d)(2). The suggestion in comments is to apply this general principle such that section 987 would require the recognition of exchange gain or loss only with respect to branch earnings and not with respect to contributed capital.

Despite the broad statements of principle quoted above, Congress provided more specific guidance regarding the treatment of branches in this regard. The Conference Report states that a remittance by a QBU "will trigger exchange gain or loss inherent in accumulated earnings or branch capital." Conference Report, 1986-3 CB Vol. 4, 675. See § 601.601(d)(2). Similarly, despite the stated requirement that QBUs must use a notional profit and loss method to determine branch taxable income, the specific method actually provided in section 987 and described in the legislative history represents a blend of a net worth method and a profit and loss method. Accordingly, the IRS and the Treasury Department believe that the more specific statements made by Congress regarding the treatment of branch exchange gain or loss reflect an intention that the methodologies of section 986(c) and section 987 not be identical.

D. The 1991 Proposed Regulations

The 1991 proposed regulations provide generally that the net income of a QBU having a functional currency different than the taxpayer is determined annually. Such determination is 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 provide for the recognition of exchange gain or loss upon a remittance from the QBU's equity pool. In general, the equity pool consists of the undistributed capital and earnings of the QBU, determined in the QBU's functional currency. The 1991 proposed regulations also provide for a basis pool, which consists of the basis

² Section 989(b)(4) provides that, "except as provided in regulations," the appropriate exchange rate is the average exchange rate for the taxable year of the QBU.

of the capital and earnings in the equity pool, expressed in the functional currency of the taxpayer. The portion of

the basis pool, expressed in the functional currency of the taxpayer, that is attributable to a remittance is

generally determined according to the following formula:

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

Section 987 gain or loss is 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 the remittance is made, less the basis associated with the remittance as determined above. One important consequence of the equity pool paradigm is that all branch equity gives rise to exchange gain or loss, regardless of whether or not that equity is held in a form that actually exposes the QBU's owner to currency fluctuations (compare assets such as cash or indebtedness to assets such as equipment).

Under the 1991 proposed regulations, a taxpayer must determine the source and character of section 987 gain or loss for all purposes of the Code, including sections 904(d), 907, and 954, by using the same method the taxpayer uses to allocate and apportion its interest expense under section 861, with certain modifications.

E. Concerns Regarding the 1991 Proposed Regulations; Notice 2000-20

Effective January 1, 1997, the IRS and the Treasury Department issued the check the box regulations implementing new elective entity-classification rules. These regulations made it possible for certain entities with a single owner to be treated for federal income tax purposes as an entity disregarded as separate from its owner (a disregarded entity or DE). As a result, businesses that had previously operated through subsidiaries could operate through structures treated for tax purposes as branches. The effect of the check the box regulations was a dramatic increase in the number of branches resulting from DE elections that are subject to section 987. This increase has greatly exacerbated the already existing problems of the 1991 proposed regulations, especially the ability of taxpayers to trigger non-economic losses (and the corresponding trap for the unwary taxpayer with non-economic gains).

As indicated above, the equity pool paradigm in the 1991 proposed regulations imputes currency gain or

loss to all equity of a QBU whether or not the assets of the QBU are economically exposed to changes in the value of the functional currency of the QBU. The IRS has faced many cases in which taxpayers have claimed substantial non-economic exchange losses largely on the basis of the 1991 proposed regulations. An example may be instructive. Assume that a domestic corporation (US Corp) with the dollar as its functional currency forms a foreign corporation in Country X and then elects under the check the box regulations to treat that corporation as a DE. The DE conducts mineral extraction and owns all the necessary equipment. The equipment owned by the DE was contributed by US Corp. The DE has no employees and contracts with a subsidiary of US Corp for the employees needed in the business of extraction. US Corp, as the entity's sole owner, claims that the DE is a QBU for purposes of section 987. The DE has minimal financial assets and conducts no activities other than mineral extraction. US Corp claims that the DE's functional currency is Country X currency. A decline in the value of Country X currency relative to the dollar does not produce any economic loss for US Corp because the assets of the DE are not financial assets subject to currency fluctuation. Nevertheless, US Corp claims under the 1991 proposed regulations that the equity of the DE, which consists almost exclusively of equipment, gives rise to a substantial non-economic exchange loss and that terminating the DE (for example, by another check the box election) triggers recognition of such loss. Taxpayers have claimed similar results under other fact patterns. The IRS and the Treasury Department have serious concerns about these types of transactions.

Although the foregoing example concerns the claiming of non-economic losses, the equity pool approach in the 1991 proposed regulations can also give rise to non-economic gains. Recently, the value of the US dollar has declined against many foreign currencies. It is likely that under these circumstances, taxpayers subject to section 987 may

have large non-economic gains built into the equity pool. The IRS and the Treasury Department believe that Congress did not intend for section 987 to generate non-economic foreign currency gains or losses.

In light of the entity-classification rules and the potential for the equity pool paradigm to generate non-economic currency gains and losses, the IRS and the Treasury Department issued Notice 2000-20, 2000-1 CB 851. See § 601.601(d)(2). Among other things, the notice indicated that the IRS and the Treasury Department were concerned that the proposed regulations may not have achieved their original goal of recognizing economic exchange gains and losses under appropriate circumstances. The notice requested comments on this and other issues.

Several comments were received in response to the notice and raised a number of important points. Two of those comments suggested replacing the equity pool paradigm in the 1991 proposed regulations with a paradigm that recognizes exchange gain or loss only on the earnings of a QBU and not its capital. As described above, the IRS and the Treasury Department believe that such an approach is inconsistent with Congressional intent as expressed in the legislative history to section 987. An earnings-only approach also would fail to address the core problem of distinguishing between items that economically give rise to exchange gain and loss and those that do not. Additionally, an earnings-only approach would produce different results for QBUs with the same net assets, depending upon whether the net assets were funded with capital or earnings. Finally, an earnings-only approach fails to take into account any foreign currency exposure on capital and so could disadvantage banks and other financial institutions, much of whose QBUs' capital may be subject to such exposure.

F. The Foreign Exchange Exposure Pool Method

The IRS and the Treasury Department believe that Congress did not intend

section 987 to permit the largely uninhibited recognition of non-economic exchange gain or loss. The 1991 proposed regulations, together with the check the box regulations, have combined to permit taxpayers to trigger non-economic losses with relative ease. Accordingly, the 1991 proposed regulations are withdrawn and are replaced with new proposed regulations that adopt the "foreign exchange exposure pool method." In general, the foreign exchange exposure pool method provides that the income of a QBU that is subject to section 987 ("section 987 QBU") is determined by reference to the items of income, gain, deduction and loss booked to the QBU in its functional currency, adjusted to reflect US tax principles. With certain exceptions, items of income, gain, deduction and loss of a section 987 QBU are translated into the functional currency of the QBU's owner at the average exchange rate for the year. However, the basis of historic assets and deductions for depreciation, depletion, and amortization of such assets are translated at the historic exchange rate. Translating these items at the historic exchange rate differs from the approach taken in the 1991 proposed regulations, which instead uses the average exchange rate. Although using the average exchange rate for translating such items might be simpler than using the historic exchange rate, it leads to the generation of non-economic foreign currency gains or losses described in this preamble.

The foreign exchange exposure pool method uses a balance sheet approach to determine exchange gain or loss, which is then recognized upon a remittance. Use of a balance sheet approach allows taxpayers and the IRS to distinguish between those items whose value fluctuates with respect to changes in the functional currency of the owner and those which do not. Under this method, exchange gain or loss with respect to "marked items" is identified annually but is pooled and deferred until a remittance is made. The IRS and the Treasury Department believe that section 988(c) identifies the items that should be treated as giving rise to exchange gain or loss for purposes of section 987. Accordingly, a marked item is generally defined as an asset or 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.

When a section 987 QBU makes a remittance, a portion of the pooled and deferred exchange gain or loss is recognized. In general, the amount taken

into account is an amount equal to the product of the owner's portion of the section 987 QBU's net unrecognized exchange gain or loss, multiplied by the owner's remittance proportion. The owner's remittance proportion generally is equal to the quotient of the amount of the remittance, divided by the aggregate basis of the section 987 QBU's gross assets (as reflected on its year-end balance sheet), without reduction for the remittance.

The source and character of exchange gain or loss recognized under section 987 for all purposes of the Code, including sections 904(d), 907 and 954, is determined by reference to the source and character of the income derived from the section 987 QBU's assets.

The IRS and the Treasury Department believe that the foreign exchange exposure pool method is consistent with section 987 and legislative intent for several reasons. First, the foreign exchange exposure pool method uses a profit and loss statement to determine the items of income, gain, deduction and loss of a section 987 QBU in its functional currency. This allows proper characterization of items of income, gain, deduction and loss. Second, exchange gain or loss must be taken into account only with respect to items of branch capital and earnings whose value fluctuates with changes in exchange rates by reference to the owner's functional currency. This comports both with Congressional intent that taxpayers recognize exchange gain or loss (but only economic exchange gain or loss) inherent in branch capital and branch earnings and with authority granted under section 987(3) to identify appropriate translation rates. Third, exchange gain or loss is recognized under section 987 only upon a remittance. Finally, the foreign exchange exposure pool method is an appropriate interpretation of the "blended" approach of section 987—that is, it incorporates certain aspects of the profit and loss method and the net worth method.

Explanation of Provisions

A. Section 1.987-1 Scope, Definitions and Special Rules

1. Scope in General

The proposed regulations provide rules for determining the section 987 taxable income or loss of a taxpayer with respect to a section 987 QBU as well as the timing, amount, character, and source of section 987 gain or loss recognized with respect to such QBU. The proposed regulations do not apply to banks, insurance companies, and similar financial entities (including,

solely for this purpose, leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts). The IRS and the Treasury Department plan to apply the foreign exchange exposure pool method adopted in the proposed regulations to such entities in subsequent guidance but believe it is appropriate to request comments regarding how the rules of the proposed regulations need to be precisely tailored to address issues unique to financial entities. Financial entities are urged to make necessary comments to help tailor the planned extension of the foreign exchange exposure pool method to such entities.

Specifically, in the context of banks, the IRS and the Treasury Department request comments on whether special rules are needed for the global dealing of currencies and securities. Comments are also requested on the relationship of sections 987 and 988 for banks. Finally, comments are requested on whether the use of exchange rate conventions is appropriate for banks and finance entities and, if so, how such conventions should be determined. In the context of insurance companies, the IRS and the Treasury Department request comments on the proper treatment of insurance reserves, surplus, and investment assets held by the separate trades or business of an insurance company. In particular, comments are requested on the proper treatment of stock held in separate accounts of a section 987 QBU of a life insurance company and the related insurance reserves established for those separate accounts. In the context of leasing companies, comments are requested regarding the treatment of stock in other leasing companies recorded on the books and records of a section 987 QBU and how the rules of sections 986 and 987 can be reconciled if stock is treated as a "marked asset" in this setting. Until regulations are issued applying the foreign exchange exposure pool method to financial entities, such entities must comply with section 987 under a reasonable method, consistently applied. For this purpose, reasonable methods include using the method described in the 1991 proposed regulations and a method that imputes section 987 gain or loss to earnings but not capital.

The proposed regulations also do not apply to trusts, estates and S corporations. The IRS and the Treasury Department plan to apply the foreign exchange exposure pool method adopted in the proposed regulations to such entities but believe it is appropriate to request comments

regarding how the rules of the proposed regulations should be applied to such entities. The IRS and the Treasury Department request comments regarding whether principles similar to those applied to partnerships should apply to these entities.

2. Taxpayers Subject to Section 987 and Related Definitions

The IRS and the Treasury Department believe that section 987 should only apply where an individual or corporation (whether foreign or domestic) has activities that constitute a trade or business under § 1.989(a)-1(c) and the trade or business has a functional currency different from the individual or corporation. In such cases, the individual or corporation will be subject to the rules of the proposed regulations if the individual or corporation is the owner of a section 987 QBU. A section 987 QBU is defined in § 1.987-1(b)(2) as an eligible QBU that has a functional currency different from its owner.

An eligible QBU is defined in § 1.987-1(b)(3) of the proposed regulations. Generally, an eligible QBU is an activity of an individual, corporation, partnership or DE that is a trade or business as defined in § 1.989(a)-1(c); maintains separate books and records as defined in § 1.989(a)-1(d) and assets and liabilities used in conducting such activities are reflected on such books and records; and the activities are not subject to the dollar approximate separate transaction (DASTM) rules of § 1.985-3. A corporation is not an eligible QBU. An individual is not a QBU under § 1.989(a)-1(b)(2)(i) and therefore cannot be an eligible QBU. In addition, and as discussed in this preamble, neither a partnership nor a DE is an eligible QBU.

In the case of ownership other than through a partnership (that is, direct ownership), the individual or corporation is treated as the owner of an eligible QBU if the individual or corporation is the tax owner of the assets and liabilities of the eligible QBU. For purposes of determining direct ownership, an individual or corporation will be treated as a direct owner of the assets and liabilities of an eligible QBU if it owns a DE that holds an eligible QBU. In such case, because the DE is not recognized as a separate entity, it cannot be a QBU under section 989 and, therefore, is not treated as an eligible QBU under the proposed regulations. However, the activities of the DE, which are treated for purposes of the Code as carried on directly by its owner, can qualify as an eligible QBU of the DE's owner.

With respect to partnerships, the IRS and the Treasury Department recognize that issues often arise as to whether the international tax provisions of the Code operate on an aggregate or an entity basis. The legislative history of subchapter K of chapter 1 of the Code provides that, for purposes of interpreting Code provisions outside of that subchapter, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular section under consideration. H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954).

In the case of section 987, the calculations under the foreign exchange exposure pool method would differ dramatically based on whether an aggregate or an entity approach is adopted. For example, if the foreign exchange exposure pool method is applied at the entity level, the partnership will make the method's calculations by reference to the partnership's functional currency. Under this approach, any foreign currency gain or loss will be an item of the partnership and will be allocated among the partners in accordance with the partnership agreement, to the extent such allocation is consistent with the provisions of subchapter K. If, in the alternative, the foreign exchange exposure pool method is applied under an aggregate approach, each partner will make its own foreign exchange exposure pool calculations by reference to the partner's functional currency and such amounts will not be subject to separate allocation under subchapter K.

The IRS and the Treasury Department believe that, on balance, an aggregate approach is more appropriate for section 987 purposes. Applying the foreign exchange exposure pool method directly at the partner level will more appropriately preserve the correct amounts of exchange gain or loss. In addition, such approach will measure the foreign currency exposure by reference to the functional currencies of the persons who generally bear the economic risk from such exposure. As a result, the proposed regulations provide that for purposes of applying the foreign exchange exposure pool method each individual or corporation that is a partner in a partnership will be considered to own indirectly an eligible QBU consisting of a portion of the assets and liabilities of the partnership allocated to it under § 1.987-7. If such eligible QBU has a different functional currency from the partner and therefore is a section 987 QBU, the foreign

exchange exposure pool method is applied with respect to those assets and liabilities. In addition, the proposed regulations provide rules for converting the items of section 987 taxable income or loss of a section 987 QBU into the functional currency of the partner (when necessary), and rules coordinating this aggregate approach with other provisions of subchapter K.

Section 1.987-1(b)(2)(ii) allows an owner to elect to treat certain section 987 QBUs with the same functional currency as a single section 987 QBU. The purpose of this rule is to simplify section 987 calculations by reducing the number of interbranch transactions that would be considered as "transfers" of assets and liabilities. This election applies only to certain section 987 QBUs of the owner. The IRS and the Treasury Department request comments regarding whether such election should be available to treat section 987 QBUs of owners that are members of a consolidated group as a single section 987 QBU and how this should be technically effectuated.

Section 1.987-1(b)(5) provides that the term "owner" for section 987 purposes does not include an eligible QBU or section 987 QBU of an owner. Under this rule, a tiered ownership structure of eligible QBUs and/or section 987 QBUs will not be respected as distinct tiers of QBUs for purposes of section 987. Rather, tiers of eligible and/or section 987 QBUs will be treated as a "flat" structure, with each QBU in the tier considered as owned directly by the ultimate non-QBU owner. For example, if a domestic corporation is the holder of the interests in a section 987 DE (section 987 DE1) and that DE owns the interests in another section 987 DE (section 987 DE2) for purposes other than U.S. tax law, the structure will not be treated as a tier of QBUs for purposes of section 987. Rather, the domestic corporation will be considered the direct holder of the interests in the section 987 branches of section 987 DE1 and DE2. This flat structure, which is consistent with the general approach taken in the proposed dual consolidated loss regulations (70 FR 29868-29907), is expected to be easier to administer for both taxpayers and the IRS and to provide more appropriate results under the section 987 rules.

3. De Minimis Rule for Certain Indirectly Owned Section 987 QBUs

The IRS and the Treasury Department recognize that it may be administratively burdensome for taxpayers to apply certain aspects of the proposed regulations to section 987 QBUs indirectly owned through

relatively small interests in partnerships. As a result, the proposed regulations provide a *de minimis* election for certain indirectly owned section 987 QBUs. Under this rule, an individual or corporation that owns a section 987 QBU indirectly through a partnership may elect not to take into account the section 987 gain or loss of such section 987 QBU, provided such individual or corporation owns, directly or indirectly, less than five percent of the section 987 partnership. Constructive ownership rules apply for purposes of determining whether the less than five percent ownership threshold is satisfied.

This *de minimis* exception only applies to recognition of section 987 gain or loss with respect to a section 987 QBU. Thus, owners of section 987 QBUs that qualify under the *de minimis* exception must comply with all other aspects of the proposed regulations, including the requirement to take into account the section 987 taxable income or loss with respect to such section 987 QBUs.

An individual or corporation that qualifies for the election (that is, because they owned less than five percent of a section 987 partnership) subsequently may fail to qualify as a result of an increase in their interest in a section 987 partnership. In such a case, taxpayers must begin taking into account the section 987 gain or loss with respect to section 987 QBUs owned through such partnerships. Similarly, taxpayers that were required to take into account section 987 gain or loss with respect to an indirectly owned section 987 QBU may reduce their ownership such that they become eligible for the *de minimis* exception and, as a result, may elect to no longer take into account section 987 gain or loss. The IRS and the Treasury Department recognize that transition issues will arise when interests in section 987 partnerships change such that individuals or corporations no longer qualify (or are able to qualify) for the *de minimis* exception. The IRS and the Treasury Department are considering such transition rules and request comments as to their application.

4. Exchange Rates

Section 1.987-1(c)(1)(i) defines the spot rate as the rate determined under the principles of § 1.988-1(d)(1), (2) and (4) on the relevant day. Section 1.987-1(c)(1)(ii) allows taxpayers to elect to use spot rate conventions that reasonably approximate the spot rate on a particular day. It is anticipated that taxpayers will be able to conform the spot rate convention for section 987 to

the spot rate conventions used under FAS 52 for financial accounting purposes. This is intended to simplify the calculations required under section 987.

In a similar attempt to simplify calculations, § 1.987-1(c)(2) defines the yearly average exchange rate as an average exchange rate for the taxable year computed under any reasonable method that is consistently applied.

Finally, § 1.987-1(c)(3) defines the historic exchange rate by reference to the spot rate on the day that assets are transferred to (or acquired by) the section 987 QBU, or on the day that liabilities are assumed (or entered into) by the section 987 QBU. The reference to the spot rate as defined in § 1.987-1(c)(1)(i) and (ii) allows taxpayers to elect to use spot rate conventions for these purposes.

5. Definitions of a Section 987 Marked Item and a Section 987 Historic Item

The definitions of a section 987 marked item and a section 987 historic item are central to the foreign exchange exposure pool method. When taken into account in the context of the calculation of net unrecognized section 987 gain or loss under § 1.987-4, the definitions distinguish those items that generate section 987 gain or loss from those that do not. The IRS and the Treasury Department believe that section 988 identifies those items properly treated as giving rise to exchange gain or loss for purposes of section 987. Thus, a marked item as defined in § 1.987-1(d) is an asset or liability reflected on the books and records of the section 987 QBU that both (1) Would generate section 988 gain or loss if held or entered into directly by the owner of the section 987 QBU and (2) is not a section 988 transaction to the section 987 QBU. It is important to exclude section 988 transactions of a section 987 QBU because section 988 already requires the section 987 QBU to recognize gain or loss from such transactions. Thus, treating such transactions as marked items for purposes of section 987 would result in double counting. Marked items give rise to exchange gain or loss under section 987. Historic items, which are defined in § 1.987-1(e) as items other than marked items, do not give rise to exchange gain or loss under section 987.

6. Elections Under Section 987

Section 1.987-1(f) provides rules for making elections under section 987. In general, the elections made under section 987 must be made by the owner of the section 987 QBU. The elections must be made with respect to a section 987 QBU for the first taxable year in

which the election is relevant, and must be made by attaching a statement to a timely filed tax return for such taxable year. Elections under section 987 are treated as methods of accounting and are governed by the general rules regarding changes in methods of accounting.

The IRS and the Treasury Department believe that a reasonable cause standard should be applied to determine whether taxpayers that fail to make a timely election are eligible for an extension of time to file elections pursuant to § 1.987-1(f) of the proposed regulations. As a result, extensions of time under §§ 301.9100-1 through 301.9100-3 will not be granted for filings under the proposed regulations. See § 301.9100-1(d).

Under the reasonable cause standard, if an owner that is permitted to file an election under the proposed regulations fails to make such a filing in a timely manner, the owner is considered to have satisfied the timeliness requirement with respect to such filing if it demonstrates, to the satisfaction of the Area Director, Field Examination, Small Business/Self Employed or the Director, Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the taxpayer's return for the taxable year, that such failure was due to reasonable cause and not willful neglect. Once the owner becomes aware of the failure, the owner must demonstrate reasonable cause and must satisfy the filing requirement by attaching the election to an amended tax return (that amends the tax return to which the election should have been attached). A written statement must be included that explains the reasons for the failure to comply.

In determining whether the taxpayer has reasonable cause, the Director shall consider whether the taxpayer acted reasonably and in good faith. Whether the taxpayer acted reasonably and in good faith will be determined after considering all the facts and circumstances. The Director shall notify the person in writing within 120 days of the filing if it is determined that the failure to comply was not due to reasonable cause or if additional time will be needed to make such determination. If the Director fails to notify the owner within 120 days of the filing, the owner shall be considered to have demonstrated to the Director that such failure was due to reasonable cause and not willful neglect.

The proposed regulations provide that elections under section 987 cannot be revoked without the consent of the Commissioner. In addition, the proposed regulations provide that the

Commissioner will consider allowing revocation of such an election if the taxpayer demonstrates significantly changed circumstances, or other circumstances that demonstrate a substantial non-tax business reason for such revocation. Finally, the IRS and the Treasury Department are considering an exception to the general revocation rule where a section 987 QBU is acquired in certain transactions that do not result in the termination of such QBU. Comments are requested as to whether such an exception is warranted and, if so, the appropriate scope of such an exception.

B. Section 1.987-2 Attribution of Items to an Eligible QBU; the Definition of a Transfer, and Related Rules

1. Attribution of Items to an Eligible QBU

i. Overview

A section 987 QBU is not itself a taxpayer and does not have its own taxable income. Items of income, gain, deduction and loss must nonetheless be attributed to such section 987 QBU for purposes of determining the owner's taxable income. The items of income, gain, deduction and loss attributed to a section 987 QBU are generally determined in the functional currency of the section 987 QBU and then translated into the functional currency of the owner. The aggregate translated amount is the section 987 taxable income or loss of the section 987 QBU. Thus, attribution rules are necessary to determine which items of income, gain, deduction and loss are attributed to the section 987 QBU.

Under section 987(3), assets and liabilities must be attributed to a section 987 QBU in order to determine the amount of section 987 gain or loss of such QBU. In some cases, a section 987 QBU of a taxpayer will not be held through an entity separate from the taxpayer that can legally own assets and incur liabilities. In addition, not all the assets and liabilities of an entity that is separate from the taxpayer may be attributable to a section 987 QBU for purposes of section 987. Moreover, assets and liabilities may constitute a section 987 QBU of a taxpayer even when such assets and liabilities are owned or incurred by separate legal entities. As a result, assets and liabilities of the taxpayer (or of entities owned by the taxpayer that are not themselves taxpayers) must be attributed to the section 987 QBU.

Neither section 987 nor the underlying legislative history provides explicit rules for attributing a taxpayer's items of income, gain, deduction, or loss

to a section 987 QBU to determine the QBU's section 987 taxable income or loss. Similarly, no explicit rules are provided in the statute or legislative history for attributing a taxpayer's assets or liabilities to a section 987 QBU to determine the section 987 gain or loss of such QBU.

Other provisions of the Code provide various methods for attributing or allocating a taxpayer's assets and liabilities, or items of income, gain, deduction and loss (items) for particular purposes. These provisions provide complex rules for making such determinations and, in many cases, require a detailed analysis of various factors and relationships involving income, assets, and activities of the taxpayer. For example, section 864(c) and the regulations thereunder provide rules for determining the income, gain, deduction, or loss of a nonresident alien individual or foreign corporation which are treated as effectively connected with the conduct of a trade or business within the United States. Other examples are §§ 1.882-5, 1.861-8 and 1.861-9T through 1.861-13T. These regulations provide rules for the allocation and apportionment of expenses, losses, and other deductions of a taxpayer. Finally, section 884(c)(2) and § 1.884-1(d) and (e) provide rules for determining U.S. assets and U.S. liabilities of a foreign corporation for purposes of the branch profits tax. As discussed below, the IRS and the Treasury Department do not believe these complex methodologies are appropriate for purposes of section 987.

ii. Books and Records Method—General Rule

The IRS and the Treasury Department believe that items should be attributed to an eligible QBU (and, if all or a portion of such eligible QBU has a different functional currency than its owner, to a section 987 QBU of such owner) to the extent they are reflected on the books and records of the eligible QBU (books and records method). The IRS and the Treasury Department believe that using a books and records method for attributing items under section 987 is consistent with other provisions of the Code involving foreign currency transactions. For example, it is consistent with the requirement under section 989(a) that a QBU maintain books and records separate from the taxpayer. It is also consistent with the requirement under section 985(b)(1) that, in order to have a functional currency other than the dollar, a QBU must keep its books and records in such currency. Moreover, the IRS and the Treasury Department believe the books

and records method is administrable for both taxpayers and the Commissioner. This is the case because the books and records method should be consistent with the taxpayer's accounting treatment of the items and, unlike the methods discussed above, it does not require a complex and factually intensive analysis of the circumstances and activities of the eligible QBU.

For the reasons described above, the proposed regulations adopt a books and records method for allocating items to an eligible QBU. The proposed regulations provide that, subject to certain exceptions, items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records of such eligible QBU, as defined in § 1.989(a)-1(d). The proposed regulations make clear that these rules apply solely for purposes of section 987. Thus, for example, the attribution rules contained in the proposed regulations do not apply for purposes of allocating and apportioning interest expense under section 864(e).

iii. Exception for Non-Portfolio Stock, Interests in Partnerships and Certain Acquisition Indebtedness

As discussed above, the IRS and the Treasury Department believe that the assets and liabilities reflected on the books and records of an eligible QBU are a reasonable approximation of the assets and liabilities that are used in the trade or business of the eligible QBU and, therefore, should be taken into account for purposes of section 987. However, the IRS and the Treasury Department believe that certain assets and liabilities should not be attributed to an eligible QBU, even if such assets and liabilities are reflected on the books and records of such QBU. The IRS and the Treasury Department believe that non-portfolio stock and interests in partnerships (and liabilities to acquire such assets), even if reflected on the books and records of the eligible QBU, should not be attributed to such QBU for purposes of section 987. This is consistent with the principle stated above that a section 987 QBU cannot be an owner of another section 987 QBU. Excluding non-portfolio stock is also consistent with the principle that non-portfolio stock cannot be used in, or held for the use in, the conduct of a trade or business in the United States. See § 1.864-4(c)(2)(iii).

As a result, the proposed regulations provide that stock of a corporation (whether domestic or foreign) and an interest in a partnership (whether domestic or foreign) are not considered to be on the books and records of an eligible QBU. The proposed regulations

provide an exception, however, for portfolio stock where the owner of the eligible QBU owns (directly or constructively) less than ten percent of the total voting power or value of the stock of such corporation. The proposed regulations also provide that indebtedness incurred to acquire stock or a partnership interest that is not treated as being reflected on the books and records of an eligible QBU should similarly be excluded from the books and records. Finally, the proposed regulations provide that items of income, gain, deduction and loss arising from ownership of stock, a partnership interest, or related acquisition indebtedness that is excluded from the general books and records rule, shall similarly not be treated as being on the books and records of the eligible QBU.

iv. Coordination With Source Rules Under Section 988

Section 988(a)(3) provides that the source of gain or loss recognized under section 988(a)(1) is determined by reference to the residence of the taxpayer or the QBU of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected. Section 1.988-4(b)(2) provides that, in general, the determination of whether an asset, liability, or item of income or expense is properly reflected on the books of a QBU is a question of fact. The regulations under section 988 further provide that such items are presumed not to be properly reflected on the books and records for this purpose if inconsistent booking practices are employed with respect to the same or similar items. Finally, the regulations provide that if such items are not properly reflected on the books of the QBU, the Commissioner may allocate the item between or among the taxpayer and its QBUs to properly reflect the source (or realization) of exchange gain or loss.

The IRS and the Treasury Department believe that rules for determining whether items are properly reflected on the books of a QBU for purposes of sourcing section 988 gain or loss should be consistent with the rules for attributing items to an eligible QBU under section 987. As a result, the proposed regulations modify the sourcing rules in the section 988 regulations 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 of a QBU.

2. Certain Assets and Liabilities of Partnerships and DEs Not Attributable to an Eligible QBU

Section 988 applies to certain transactions described in section 988(c) if the transaction is denominated (or determined by reference to) a currency that is not the functional currency of the taxpayer or QBU of the taxpayer. Thus, in order to determine if a transaction is subject to section 988, it must be determined whether a transaction is attributable to the taxpayer or a QBU of the taxpayer.

Under the current section 989 regulations, a partnership is a QBU even if it does not have activities that constitute a trade or business (“*per se* QBU”). As a result, a partnership may have a functional currency different than its partners and section 988 is applied at the partnership level with respect to section 988 transactions properly attributable to the partnership. These regulations propose to amend section 989 to provide that a partnership is no longer a *per se* QBU of its partners, but instead the activities of such partnership may be treated as a QBU.

As discussed above, the IRS and the Treasury Department will generally apply either an entity or an aggregate approach with respect to partnerships depending on which approach more appropriately carries out the purpose of the particular Code section under consideration. Following the amendments made by the proposed regulations, and because only certain activities of a partnership (and not the partnership itself) can qualify as a section 987 QBU, the IRS and the Treasury Department believe that it is appropriate, in cases where an asset or liability of a partnership is not reflected on the books and records of an eligible QBU of the partnership, to determine whether section 988 applies by reference to the functional currencies of the partners. The IRS and the Treasury Department believe that this rule will have limited application and will apply, for example, where the only activity of a partnership is the incurrence of a liability used to acquire stock that is held by the partnership. The proposed regulations provide examples illustrating the application of this rule.

As discussed above, the proposed regulations provide that a DE itself is not an eligible QBU and, instead, certain activities of the DE will be treated as an eligible QBU of the owner to the extent a separate set of books and records with respect to such activities are maintained. Thus, an issue similar to that discussed above with respect to partnerships will arise where the DE is

the local law owner of certain assets or the local law obligor on certain liabilities, which are not reflected on the books and records of an eligible QBU held by the DE. The proposed regulations provide that the determination of whether section 988 (rather than section 987) applies with respect to transactions involving assets and liabilities of a DE that are not attributable to an eligible QBU is determined by reference to the functional currency of the owner of such DE.

3. Definition of a Transfer

i. Overview

Section 987(3) provides, in part, that taxable income of a taxpayer shall be determined by making proper adjustments (as prescribed by the Secretary) for transfers of property between qualified business units of the taxpayer having different functional currencies. Similarly, the legislative history to section 987 refers to contributions to, and remittances from, QBUs. See, H.R. Conf. Rep. No. 841, 99th Cong. 2d. Sess. II 673-76 (1986). However, neither the statute nor the legislative history defines the terms “transfer,” “contribution,” or “remittance.”

As noted above, section 987 QBUs can be divisions of an owner that have no legal distinction separate from their owner. Section 987 QBUs can also be owned indirectly through partnerships, where they have legal distinction separate from their owners. Moreover, as a result of the entity classification regulations, a section 987 QBU held through a DE can have legal distinction separate from its owner, even though the section 987 QBU is treated as a division of the owner for federal income tax purposes. As a result, assets and liabilities can be transferred between an owner and a section 987 QBU in a manner that has legal significance (that is, a distribution from a section 987 partnership), or in a manner that has no legal significance because the transfers are simply between divisions of the same legal entity (that is, a transfer involving divisions of a taxpayer that is reflected through accounting entries).

ii. Disregarded Transactions

The definition of a transfer under the proposed regulations includes transactions that are regarded for both legal and tax purposes, and transactions that are regarded for legal purposes, but disregarded as transactions for tax purposes (“disregarded transactions”). For this purpose, the term disregarded transaction is treated as including the

recording of an asset or liability on one set of books and records, if the recording is the result of such asset or liability being removed from another set of books and records of the same person or entity (including a DE or partnership).

The proposed regulations provide that an asset or liability is treated as transferred to or from a section 987 QBU if, as a result of a disregarded transaction, such asset or liability is reflected, or is not reflected, respectively, on the books and records of the section 987 QBU. For example, if an owner of a section 987 DE loans cash to the section 987 QBU held by the section 987 DE, the loan is disregarded for Federal income tax purposes. However, as a result of such disregarded transaction, the loaned cash is reflected on the books and records of the section 987 QBU and, therefore, is treated as transferred to such section 987 QBU.

iii. Certain Contributions to, and Distributions From, Partnerships

The proposed regulations also provide that transfers to and from section 987 QBUs include certain contributions of assets to, or distributions of assets from, a section 987 partnership. For example, an asset contributed by a partner to a section 987 partnership is treated as transferred to an indirectly owned section 987 QBU of the partner if the asset is reflected on the section 987 QBU's books and records following such contribution. The proposed regulations provide similar rules for assumptions of liabilities between a section 987 partnership and its partners.

iv. Certain Acquisitions and Dispositions of Interests in DEs and Partnerships

The proposed regulations also provide that transfers to or from a section 987 QBU may occur as a result of certain acquisitions (including by contribution) and dispositions of interests in DEs and partnerships. For example, if a partner in a section 987 partnership sells a portion of its interest in such partnership, the sale results in a transfer from the partner's indirectly owned section 987 QBU to the extent assets and liabilities are not reflected on the books and records of such QBU as a result of such sale.

v. Change in Form of Ownership

The owner of a section 987 QBU can change its form of ownership in all or a portion of such section 987 QBU. Such changes in form of ownership often occur in a manner that does not affect the operation of the eligible QBU (or its status as an eligible QBU), but rather only changes the owner's interest in its

section 987 QBU. For example, a direct owner of a section 987 QBU that is owned through a section 987 DE can change to being an indirect owner of all or a portion of such section 987 QBU, if the interests in the section 987 DE are transferred to a partnership.

Changes in form of ownership of a section 987 QBU can occur through actual or deemed transactions involving the section 987 QBU itself, or actual or deemed transactions involving interests in a section 987 DE or section 987 partnership that owns such QBU. For example, certain conversions of DEs to partnerships, or partnerships to DEs, result in deemed transactions pursuant to Rev. Ruls. 99-5, 1999-1 CB 434, and 99-6, 1999-1 CB 432. See § 601.601(d)(2). Deemed transactions with respect to partnerships also occur pursuant to section 708(b) and the regulations thereunder.

The IRS and the Treasury Department believe that changes in form of ownership should result in a transfer only to the extent such change affects the assets and liabilities attributable to the section 987 QBU of the owner. As a result, the proposed regulations provide that a mere change in form of ownership of a section 987 QBU does not result in a transfer to or from the section 987 QBU. Instead, the proposed regulations provide that the determination of whether a transfer has occurred in such cases should be made under the general transfer rules, discussed above. Moreover, the proposed regulations clarify that deemed transactions (for example, pursuant to Rev. Ruls. 99-5 and 99-6) shall not be taken into account for purposes of determining whether there is a transfer.

vi. General Tax Law Principles

The proposed regulations clarify that general tax law principles, including the circular cash flow, step-transaction, and substance-over-form doctrines apply for purposes of determining whether there is a transfer of an asset or liability to or from a QBU. For example, if a shareholder of a corporation that directly owns a section 987 QBU transfers property to the corporation and the property is recorded on the books and records of the corporation's section 987 QBU, the shareholder is first treated as transferring the property to the corporation, and then the corporation is treated as transferring the property to the section 987 QBU in a disregarded transaction.

4. Adjustments to Items Reflected on the Books and Records

As noted above, a section 987 QBU of a taxpayer may not be an entity separate from the taxpayer that can legally own assets and incur liabilities. As a result, recording (or failing to record) an asset or liability on the books and records may, other than for purposes of section 987, have little significance for tax or legal purposes. In addition, transfers between section 987 QBUs of the same owner that are divisions of the same legal entity may have no legal significance and are accomplished only through journal entries on the books and records of such section 987 QBUs. As a result, the IRS and the Treasury Department are concerned that, in certain circumstances, transfers to or from a section 987 QBU may be structured solely to achieve advantages under section 987, especially given that such transfers may have little or no significance from a legal or business perspective.

In Notice 2000-20, the IRS and the Treasury Department expressed similar concerns in connection with taxpayers taking positions that certain contributions and distributions triggered foreign currency losses prematurely with respect to transactions that were undertaken for tax purposes, but lacked meaningful non-tax economic consequences. The notice provided that the IRS and the Treasury Department believe that circular cash flows and similar transactions lacking economic substance will not result in recognition of foreign currency losses under general tax principles because such transactions are not properly treated as transfers or remittances under section 987.

The IRS and the Treasury Department continue to be concerned about transactions that are undertaken for tax purposes and lack meaningful non-tax economic consequences. As a result, the proposed regulations provide the Commissioner the ability to allocate assets and liabilities, and items of income, gain, deduction and loss, where a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU (including an eligible QBU owned indirectly through a partnership) is the avoidance of U.S. tax under section 987. The proposed regulations also provide various factors that indicate whether recording (or failing to record) an item on books and records has as a principal purpose the avoidance of U.S. tax under section 987. For example, factors indicating that such tax avoidance was not a principal purpose of recording (or not recording) an item include doing so

for a substantial and bona fide business purpose, or in a manner that is consistent with the economics of the underlying transaction.

5. Translation of Items Transferred to a Section 987 QBU

The proposed regulations provide translation rules for the transfer of assets and liabilities to a section 987 QBU. Under the proposed regulations, if an asset or a liability is transferred to a section 987 QBU, such items are translated into the QBU's functional currency at the spot rate on the day of transfer. No translation is required for assets or liabilities denominated in the functional currency of the section 987 QBU.

The proposed regulations provide special rules for items transferred to a section 987 QBU where such items are denominated in (or determined by reference to) the owner's functional currency. Such items are not translated and instead are carried on the balance sheet in the owner's functional currency since no foreign currency exposure with respect to the owner is created by such items.

6. Interaction With Other Foreign Currency Provisions

The IRS and the Treasury Department are considering whether the attribution and transfer rules provided under the proposed regulations should apply with respect to other foreign currency provisions in the Code. For example, the IRS and the Treasury Department are considering whether the attribution rules under the proposed regulations should apply to determine the functional currency of a QBU under section 985. As a result, comments are requested on the interaction of these rules with other foreign currency provisions.

C. Section 1.987-3 Determination of the Items of Action 987 Taxable Income or Loss of an Owner of a Section 987 QBU

In general, the term "section 987 taxable income" refers to the items of income, gain, deduction or loss attributed to the section 987 QBU under § 1.987-2(b), translated into the functional currency of the owner. The allocation of expenses such as interest under other provisions are not taken into account for this purpose. Section 987 taxable income is calculated by determining each item of income, gain, deduction or loss in the section 987 QBU's functional currency under § 1.987-3(a), and then translating those items into the owner's functional currency using the exchange rates

provided in § 1.987-3(b). Items of income, gain, deduction or loss of a section 987 QBU that are denominated in (or determined by reference to) the functional currency of the owner are not translated and are not treated as section 988 transactions to the section 987 QBU. Transactions denominated in (or determined by reference to) a currency that is neither the functional currency of the owner nor of the section 987 QBU are subject to the generally applicable rules under section 988 determined with respect to the functional currency of the section 987 QBU.

When basis recovery is required with respect to an historic asset, either in computing gain or loss on the sale or exchange of such asset, or in determining cost recovery deductions (such as depreciation or depletion), the proposed regulations require the use of the historical exchange rate associated with the particular asset. Thus, for example, where a section 987 QBU sells an historic asset, the amount realized will be translated into the owner's functional currency using the yearly average exchange rate (or, if properly elected, the spot rate), but the adjusted basis will be translated using the historic exchange rate associated with that asset. The use of different exchange rates for amount realized and adjusted basis is designed to more closely reflect the economic gain or loss to the owner of the section 987 QBU than the 1991 proposed regulations. The same is true for depreciation or other cost recovery deductions that are claimed with respect to historic assets of a section 987 QBU.

Special translation rules are provided with respect to the disposition of marked assets (other than functional currency cash of the section 987 QBU). Generally, the amount realized and basis are translated at the same exchange rates. The purpose of these special rules is to assure that foreign currency gain or loss (as opposed to gain or loss not related to movements in exchange rates) is reflected through the balance sheet calculations of § 1.987-4 and not through the profit and loss calculations of § 1.987-3. Cash is not included in these special rules because the disposition of cash cannot generate profit or loss to the section 987 QBU for purposes of § 1.987-3.

D. Section 1.987-4 Determination of Net Unrecognized Section 987 Gain or Loss of a Section 987 QBU

Section 1.987-4 provides the mechanics for determining "net unrecognized section 987 gain or loss" and, when combined with § 1.987-5, form the mathematical core of the

foreign exchange exposure pool method. In summary, § 1.987-4 uses a balance sheet to distinguish the items of a section 987 QBU that give rise to section 987 gain or loss (section 987 marked items) from those that do not (section 987 historic items). This approach avoids the distortions caused by the 1991 proposed regulations that impute section 987 gain or loss to all assets of a section 987 QBU, even those assets the value of which does not fluctuate with currency movements. Generally, annual comparison of the change in the value of section 987 marked items on the opening and closing balance sheets due to changes in exchange rates gives rise to unrecognized section 987 gain or loss. This unrecognized section 987 gain or loss is aggregated with similar amounts determined for prior years (to the extent not previously taken into account) and is taken into account by the owner under the rules of § 1.987-5 upon a remittance by the section 987 QBU.

Under § 1.987-4(a) and (b), net unrecognized section 987 gain or loss is computed annually and is equal to the sum of the "unrecognized section 987 gain or loss for the current taxable year" and the "net accumulated unrecognized section 987 gain or loss for all prior taxable years." A section 987 QBU's net accumulated unrecognized section 987 gain or loss 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 a remittance for all such taxable years. For section 987 QBUs in existence prior to the effective date of these regulations, a section 987 QBU's net accumulated unrecognized section 987 gain or loss includes amounts taken into account under the transition rules of § 1.987-10.

Unrecognized section 987 gain or loss is determined under a seven step calculation. Under the first step in § 1.987-4(d)(1), the "owner functional currency net value" of the section 987 QBU is determined under § 1.987-1(e) at the close of the taxable year in the functional currency of the owner. This is a balance sheet calculation under which the basis (or amount, in the case of a liability) of each section 987 marked item is translated into the owner's functional currency at the spot rate on the last day of the taxable year. Section 987 historic items are translated into the owner's functional currency at the historic exchange rate and, therefore, do not give rise to exchange gain or loss. The amount of liabilities determined in the owner's functional currency is subtracted from the value of the assets

determined in the owner's functional currency to result in the owner functional currency net value of the section 987 QBU at the close of the taxable year. The owner functional currency net value of the section 987 QBU at the close of the preceding taxable year is subtracted from the owner functional currency net value of the section 987 QBU at the close of the current taxable year to yield the change in owner functional currency net value of the section 987 QBU for the taxable year expressed in the owner's functional currency.

Generally, three components are reflected in the change in owner functional currency net value of the section 987 QBU for a taxable year. First, taxable income or loss of the section 987 QBU will result in increases or decreases in net assets, and will therefore affect net value. Second, transfers of assets or liabilities to or from the section 987 QBU will affect net value. Finally, any remaining change in net value (as measured in the owner's functional currency) results from changes in the value of the section 987 QBU's marked assets and liabilities. In order to isolate the change in value due to foreign currency movements with respect to section 987 marked assets and liabilities, the other changes must be reversed out. That is the function of steps 2 through 7 of § 1.987-4(d).

The unrecognized section 987 gain or loss when aggregated with similar amounts for prior years (that were not previously taken into account) yields a pool of "net unrecognized section 987 gain or loss" all or part of which is to be triggered upon a remittance or termination.

E. Section 1.987-5 Recognition of Section 987 Gain or Loss

Section 1.987-5 of the proposed regulations provides the method for determining the amount of section 987 gain or loss a taxpayer must recognize in a taxable year. Generally, the amount of section 987 gain or loss recognized in a taxable year equals the net unrecognized section 987 gain or loss of the section 987 QBU determined under § 1.987-4 on the last day of such taxable year, multiplied by the owner's remittance proportion. The pool of net unrecognized section 987 gain or loss includes both unrecognized section 987 gain or loss on marked items for the current year and unrecognized section 987 gain or loss on marked items for prior years (that has not yet been taken into account). A portion of the § 1.987-4 pool of unrecognized section 987 gain or loss is triggered by a net transfer or "remittance" to the owner by a section

987 QBU during the owner's taxable year. Generally, the owner's remittance proportion is equal to the quotient of the amount of the remittance divided by the aggregate adjusted basis of the section 987 QBU's gross assets (as reflected on its year end balance sheet), without reduction for the remittance.

The 1991 proposed regulations define a remittance as the amount of any transfer from a QBU branch to the extent the amount of transfers during the year does not exceed the year end balance of the equity pool. Transfers are limited in the 1991 proposed regulations by a daily netting rule that takes into account only the amount of property distributed from the QBU branch that exceeds the amount of property transferred by the taxpayer to the QBU branch in a single day. The IRS and the Treasury Department believe that the daily netting rule of the 1991 proposed regulations is not easily administered and causes distortions in the amount of a remittance. For example, taxpayers have taken the position that a remittance followed a short time later by an equal contribution to a QBU branch can trigger recognition of section 987 gain or loss even though there has been no economic change in position of the QBU branch. The IRS and the Treasury Department believe this approach is inappropriate and provides incentives for circular cash flows used to manipulate amounts of remittances. This daily netting rule is eliminated in the proposed regulations to reduce administrative burdens on both the IRS and taxpayers, and to eliminate both taxpayer favorable and taxpayer unfavorable distortions that it can create.

Section 1.987-5(c) of the proposed regulations defines a remittance as the excess of total transfers from the section 987 QBU to the owner determined in the owner's functional currency on an annual basis over total transfers from the owner to the section 987 QBU determined on an annual basis. Solely for purposes of determining the amount of a remittance under § 1.987-5(c), the amount of liabilities transferred from the owner to the section 987 QBU is treated as a transfer of assets from the section 987 QBU to the owner. Similarly, the amount of liabilities transferred from the section 987 QBU to the owner is treated as a transfer of assets from the owner to the section 987 QBU. The IRS and the Treasury Department recognize that section 987 QBUs actively engaged in business may have a significant number of transactions that are treated as transfers to and from the owner pursuant to § 1.987-2(c). It is anticipated that the

annual netting rule will help to reduce complexity and administrative burden for taxpayers and the IRS by treating the net amount of transfers as a single annual remittance. For purposes of determining the annual remittance, only assets and liabilities considered transferred pursuant to § 1.987-2(c) will be taken into account.

The remittance is divided by the total adjusted basis of section 987 gross assets, expressed in the functional currency of the owner, reflected on the section 987 QBU balance sheet pursuant to § 1.987-2 (increased by the amount of the remittance) to determine the remittance proportion. The IRS and the Treasury Department considered a number of different measures for determining the amount of section 987 gain or loss triggered upon a remittance. The adjusted basis of gross section 987 QBU assets was selected as the measure because it avoids administrative concerns raised by alternative methods and limits the potential volatility associated with the recognition of section 987 gain or loss. In particular, the adjusted basis of gross section 987 QBU assets measure avoids the significant administrative burdens associated with a section 987 QBU accumulated earnings approach that would require taxpayers to maintain post-1986 accumulated earnings pools for each section 987 QBU. The IRS and the Treasury Department also considered the use of net section 987 QBU assets as a potential measure. Although the net section 987 QBU assets measure does not raise the same administrative burdens as an earnings based approach, the IRS and the Treasury Department were concerned about the volatility of recognizing section 987 gain or loss using a net asset measure. For example, if a section 987 QBU's gross assets are equal to its liabilities, section 987 gain or loss would be deferred. On the other hand, a small amount of income could increase section 987 QBU net assets slightly above zero and all accumulated section 987 gains or losses could be triggered with a very small remittance. The IRS and the Treasury Department believe that gross assets is a reasonable proxy for post-1986 accumulated earnings in this context, can be administered relatively easily, and will reduce the volatility and potential for distortion described in this preamble.

F. Section 1.987-6 Character and Source

Section 987(3)(B) requires that a taxpayer make proper adjustments (as prescribed by the Secretary) for certain transfers of property between QBUs of

the taxpayer, including treating section 987 gain or loss as ordinary income or loss and sourcing such gain or loss by reference to the source of income giving rise to post-1986 accumulated earnings. Section 987 is silent on the method of characterizing section 987 gain or loss for purposes of the Code. Nevertheless, the IRS and the Treasury Department believe that it is necessary to characterize section 987 gain or loss for the proper operation of certain other sections of the Code. For example, the character of section 987 gain must be determined for purposes of determining whether all or a portion of such gain qualifies as subpart F income under section 954. This characterization is necessary to prevent section 987 from being used as a vehicle to avoid the rules of section 954(c)(1)(D) with respect to certain section 988 transactions. In addition, section 987 gain or loss must be characterized for purposes of determining the foreign tax credit limitation under section 904(d). As a result, and pursuant to sections 987(3) and 989(c)(5), the proposed regulations characterize section 987 gain or loss for all purposes of the Code, including for purposes of sections 904(d), 907 and 954.

In accordance with section 987(3)(B), § 1.987-6(a) provides that section 987 gain or loss is ordinary income or loss. Moreover, the IRS and the Treasury Department believe that rules governing the source and character of section 987 gain or loss for other Code sections should be consistent. The IRS and the Treasury Department are concerned, however, that sourcing and characterizing section 987 gain or loss by reference to post-1986 accumulated earnings would give rise to substantial complexity by requiring taxpayers to track the earnings of section 987 QBUs in section 904(d) categories over prolonged periods. The compliance burden would be considerable for taxpayers with large numbers of section 987 QBUs. Accordingly, the IRS and the Treasury Department believe that it is appropriate to use the average tax book value of assets in the year of remittance as determined under § 1.861-9T(g) as a proxy for post-1986 accumulated earnings in the context of section 987.³ In the context of section 987, use of a single year's assets should generally reflect the activities of a section 987 QBU that give rise to a section 987

QBU's accumulated earnings and will significantly minimize complexity. The tax book value method set forth in § 1.861-9T(g) as applied to section 987 QBUs has been amended to provide greater consistency with the proposed regulations. The modified gross income method described in § 1.861-9T(j) cannot be used to characterize section 987 gain or loss as the IRS and the Treasury Department believe that gross income earned in a single year is not a sufficient proxy for accumulated earnings.

The IRS and the Treasury Department recognize that the characterization rule contained in the proposed regulations applies to provisions other than the international tax rules. In addition, the IRS and the Treasury Department recognize that special considerations may arise in connection with applying this characterization rule to various domestic provisions. For example, special considerations may arise when characterizing section 987 gain or loss for rules that apply to regulated investment companies (RICs) and real estate investment trusts (REITs). The IRS and the Treasury Department are studying the application of the characterization rules to these other provisions and request comments. As a result, the proposed regulations reserve on the method for characterizing and sourcing section 987 gain or loss for purposes of RICs and REITs.

G. Section 1.987-7 Partnership Rules

1. Scope

Section 1.987-7 provides rules for determining a partner's share of the assets and liabilities of an eligible QBU held indirectly through a section 987 partnership. It also provides rules coordinating the application of section 987 with subchapter K of chapter 1 of the Code.

2. Allocation of Assets and Liabilities

In order to apply the foreign exchange exposure pool method at the partner level, as discussed above, each partner must determine its share of the assets and liabilities of an eligible QBU and, to the extent applicable, a section 987 QBU owned indirectly through the section 987 partnership. Section 1.987-7 provides a general rule that requires the allocation of the assets and liabilities of the partnership's eligible QBUs to the partners in a manner that is consistent with the manner in which the partners have agreed to share the economic benefits and burdens corresponding to such assets and liabilities, taking into account the rules and principles of sections 701 through 761 and the

regulations thereunder, including section 704(b) and § 1.701-2.

The IRS and the Treasury Department believe that this general rule is appropriate because it will allocate the assets and liabilities consistent with the partners' economic arrangement. The IRS and the Treasury Department recognize that any rule which attempted to allocate the assets and liabilities without regard to such economic arrangement would have the effect of distorting each partner's section 987 gain or loss attributable to its section 987 QBU and, as a result, would be inappropriate. Moreover, the IRS and the Treasury Department are concerned that taxpayers could attempt to inappropriately shift a partner's share of the underlying assets and liabilities of a section 987 QBU owned indirectly through a section 987 partnership to distort the partner's section 987 gain or loss. As a result, the Commissioner may review such allocations to ensure that they are consistent with the economic arrangement of the partners and the principles of subchapter K of Chapter 1 of the Code and the applicable regulations, including section 704(b) and § 1.701-2.

Moreover, the IRS and the Treasury Department are considering whether it would be appropriate, when these regulations are finalized, to provide a safe harbor. Under such a safe harbor, the assets and liabilities of an eligible QBU would be deemed to be allocated in a manner which appropriately reflects each partner's share of the economic benefits and burdens if certain conditions are satisfied. For example, the safe harbor could provide that the assets and liabilities are deemed to be allocated in a manner consistent with each partner's share of the underlying economic benefits and burdens provided the assets, to the extent of a partner's share of partnership capital, are allocated in accordance with such capital and any excess assets (assets in excess of partnership capital) are allocated consistent with the manner in which the partners have agreed to share the economic burden of the liabilities incurred to acquire such assets. The IRS and the Treasury Department request comments as to whether a safe harbor should be included and, if so, what form such safe harbor should take.

3. Coordination with subchapter K

A partner must take into account its share of the items of income, gain, deduction, or loss of its section 987 QBU owned indirectly through a partnership and, under § 1.987-3, must convert such items into its functional

³Notably, because section 987 gain or loss may be derived from assets acquired with earnings and capital of a section 987 QBU (or from liabilities entered into by the QBU), using post-1986 accumulated earnings to characterize exchange gain or loss under section 987 may not reflect all items giving rise to such gain or loss.

currency. In addition, a partner must take into account any section 987 gain or loss of the section 987 QBU determined in the partner's functional currency. In both situations, the partner's adjusted basis in its partnership interest must be adjusted in order to avoid the duplication of income or loss attributable to the section 987 QBU. Section 1.987-7 provides a rule regarding the appropriate adjustments which must be made to the partner's adjusted basis in the section 987 partnership to ensure that no such duplication occurs.

A partner is also required under section 752 to adjust its basis in its interest in the section 987 partnership to take into account liabilities of the section 987 partnership. As a result, the proposed regulations provide rules for determining the appropriate adjustments to such basis required under section 752 in the case of an increase or a decrease in such partner's share of the liabilities of the partnership reflected on the books and records of a section 987 QBU. In addition, the proposed regulations provide rules for determining the amount of such liability, as determined in the partner's functional currency, which must be taken into account on the sale or exchange of a partnership interest under section 752(d).

The proposed regulations also clarify, consistent with section 985(a), that a partner's adjusted basis in its partnership interest is determined in the functional currency of the partner. Moreover, the proposed regulations provide that the fluctuations between the partner's functional currency and the functional currency of the section 987 QBU do not affect such partner's adjusted basis in its partnership interest. Instead, such fluctuations are taken into account under the foreign exchange exposure pool method of § 1.987-4.

4. Comments

The proposed regulations do not address the adjustments which would occur under section 752 when there is an assumption by a partnership of a partner's liability that is denominated in a functional currency different from the partner and which, as a result, is subject to section 988 in the hands of the partner. In such cases, the partner will be deemed to receive a distribution of money, under section 752(b), regardless of whether, following the assumption, the liability is reflected on the books and records of the partnership's qualified business unit. In such cases, it is unclear whether the amount of the distribution should be determined by reference to the spot rate (on the date of

assumption) or the historic exchange rate (on the date the liability was originally incurred by the partner). In addition, this issue raises concerns as to how section 988 would operate upon such assumption. The IRS and Treasury Department request comments on this issue and whether provisions should be included in section 988 to better coordinate the operation of section 987 and section 988 in this context. In addition, comments are requested on whether provisions should be included in section 988 in order to coordinate the aggregate approach, adopted in these proposed regulations, with respect to certain assets and liabilities that are not reflected on an eligible QBU of the partnership.

In addition to the issues specifically addressed in the proposed regulations, the IRS and the Treasury Department request comments on additional provisions which should be included to coordinate the provisions of section 987 with subchapter K of chapter 1 of the Code. Specifically, comments are requested as to how capital accounts maintained under section 704 should be adjusted to take into account section 987 gain or loss. In addition, comments are requested as to whether section 987 loss should be subject to the limitation provided under section 704(d) and, if so, how such limitation might be applied. Finally, comments are requested as to any other provisions of subchapter K of chapter 1 of the Code on which guidance should be provided.

H. Section 1.987-8 Termination of a Section 987 QBU

1. General termination rules

The proposed regulations set forth circumstances in which a section 987 QBU will terminate. For purposes of § 1.987-5, a termination of a section 987 QBU is treated as a remittance of all the gross assets of the section 987 QBU to its owner. The termination rules recognize that an owner carries on a trade or business through its section 987 QBU and when the owner stops conducting that trade or business through its section 987 QBU, any section 987 gain or loss should be recognized in full. Thus, a termination generally occurs when: (1) The activities of the section 987 QBU cease; (2) substantially all of the assets (as defined in section 368(a)(1)(C)) of the section 987 QBU are transferred to its owner; or (3) the owner of the section 987 QBU ceases to exist.

In addition, a termination occurs when a foreign corporation that is a controlled foreign corporation (CFC) that is the owner of a section 987 QBU

ceases to be a CFC because at that point any section 987 gain or loss cannot be subpart F income and may be deferred indefinitely.

2. Exceptions for Certain Section 381 Transactions

Section 987 gain or loss generally arises during the period that an owner has a section 987 QBU. The section 987 gain or loss is analogous in some respects to a tax attribute under section 381. As a result, the proposed regulations provide that a termination does not generally occur when other tax attributes under section 381 are carried over in a liquidation under section 332 or an asset reorganization under section 368(a). However, inbound and outbound liquidations and reorganizations terminate a section 987 QBU because these transactions materially change the circumstances in which section 987 gain or loss is taken into account.

3. Treatment of Inbound Liquidations and Inbound Asset Reorganizations

Although the proposed regulations treat inbound liquidations under section 332 and inbound asset reorganizations under section 368(a) as terminations, the IRS and the Treasury Department are considering whether such treatment is appropriate in all cases.

The IRS and the Treasury Department believe that the better view, taking into account various policies, is to support the treatment of inbound transactions as terminations. For example, such treatment may prevent the importation of a tax attribute that was generated offshore. Concerns over such attribute importation are similar to those that were addressed in § 1.367(b)-3(e) and (f) and section 362(e). In addition, treating inbound asset transactions as terminations is consistent with the results that would obtain if the foreign currency gain or loss attributable to the QBU were taken into account under section 988, rather than section 987.

The IRS and the Treasury Department acknowledge, however, that other policies may support the position that such inbound transactions should not be terminations. One of the reasons the proposed regulations treat certain section 381 transactions as terminations is because amounts taken into account under section 987 (that is, section 987 taxable income or loss, and section 987 gain or loss) generally become subject to a lesser degree of U.S. taxation after the section 381 transaction than was the case before the transaction (that is, when the section 987 QBU goes from being owned by a domestic corporation to being owned by a foreign corporation). This is not the case in

certain inbound transactions because amounts taken into account under section 987 are generally subject to a greater degree of U.S. taxation after the inbound transaction (when the section 987 QBU is owned by a domestic corporation) than was the case before the transaction (when the section 987 QBU was owned by a foreign corporation).

The IRS and the Treasury Department request comments on whether it is appropriate to treat these inbound asset transactions as terminations. Such comments should take into account the policy concerns discussed in this preamble.

4. Section 351 Exchanges and Transactions Within a Consolidated Group

The proposed regulations provide that a termination occurs when the owner of a section 987 QBU transfers the QBU to another corporation in exchange for stock in a transaction qualifying under section 351. The termination occurs because the owner no longer has a section 987 QBU.

The IRS and the Treasury Department are studying ways to apply the intercompany transaction rules of § 1.1502-13 to section 987 transactions within a consolidated group. For example, the IRS and the Treasury Department are considering whether transfers qualifying under section 351 which would trigger a remittance or termination under the proposed regulations should qualify for deferral under § 1.1502-13. The IRS and the Treasury Department request comments on the interplay between § 1.1502-13 and the proposed regulations and the timing of the inclusion of the deferred section 987 gain or loss.

I. Section 1.987-9 Recordkeeping Rules

Given the detailed nature of the calculations required under these regulations, § 1.987-9 articulates the records that taxpayers must keep. A taxpayer must keep such records as are sufficient to establish the section 987 QBU's section 987 taxable income or loss, its section 987 gain or loss, and the transition method used for section 987 QBUs under § 1.987-10. Section 1.987-9(b) lists supplemental records that must be maintained.

J. Section 1.987-10 Transition Rules

The transition rules of § 1.987-10 apply to a taxpayer that is the owner of a section 987 QBU on the transition date. Such a taxpayer must transition to the foreign exchange exposure pool method of these regulations whether or

not such taxpayer made determinations required under section 987 in prior years. A taxpayer that failed to make required determinations under section 987 in prior years or that used an unreasonable method in prior years can only use the fresh start transition method of § 1.987-10(c)(4) as described in this preamble. Generally, use of the 1991 proposed section 987 regulations method (see, Examples 1 and 3 of § 1.987-10(d)) or an "earnings only" section 987 method (see, Example 2 of § 1.987-10(d)) will be considered a reasonable method for purposes of § 1.987-10. However, for example, the recognition of section 987 gain or loss with respect to stock under any method, where the gain or loss does not reflect economic gain or loss derived from the movements in exchange rates, will be carefully scrutinized by the IRS and may be considered unreasonable based on the facts and circumstances of the particular case.

The transition date is the first day of the first taxable year to which these section 987 regulations apply.

Comments are requested on the application of these transition rules to partnerships which were, under the current proposed regulations, treated as qualified business units for purposes of section 987. Comments are also requested on the treatment of qualified business units of such partnerships.

Generally, § 1.987-10(c) allows a taxpayer to transition to the foreign exchange exposure pool method set forth in these regulations under one of two methods (the "deferral transition method" or the "fresh start transition method"). Under the conformity rules of § 1.987-10(c)(2), this election must be applied with respect to all members that file a consolidated return with the taxpayer and any controlled foreign corporation as defined in section 957 in which the taxpayer owns more than 50 percent of the voting power or stock (as determined in section 957(a)). This conformity rule is necessary to prevent taxpayers and certain related entities from taking inconsistent positions with respect to qualified business units which have unrecognized section 987 gains and losses. The IRS and the Treasury Department request comments on concerns that may arise by the inclusion of certain controlled foreign corporations in the conformity rule.

Under the deferral transition method of § 1.987-10(c)(3), section 987 gain or loss is determined under the taxpayer's prior section 987 method on the transition date as if all qualified business units of the taxpayer terminated on the last day of the taxable year preceding the transition date. The

deemed termination is solely for purposes of measuring section 987 gain or loss in order to transition to the foreign exchange exposure pool method and does not apply for any other purpose. Section 987 gain or loss determined on the deemed termination is not immediately recognized. Rather, it is deferred by treating it as net unrecognized section 987 gain or loss of the relevant section 987 QBU. Such gain or loss will be recognized under the remittance rules of § 1.987-5 for periods after the transition date. The owner of a qualified business unit that is deemed to terminate under these rules is treated as having transferred all of the assets and liabilities attributable to the qualified business unit to a new section 987 QBU on the transition date. In order to avoid double counting, § 1.987-10(c)(3)(ii) provides that the exchange rates used to determine the amount of an asset or liability transferred from the owner to the new section 987 QBU on the transition date (that is, for purposes of making later calculations under § 1.987-4) is determined with reference to the historic exchange rates on the day the asset was acquired or liability entered into by the qualified business unit deemed terminated. That exchange rate is then adjusted to take into account an allocation of section 987 gain or loss determined under the deferral transition method. If the taxpayer is not able to trace an historic exchange rate to a particular asset or liability, then the exchange rate must be determined under a reasonable allocation method, consistently applied, that takes into account an allocation of the aggregate basis and an allocation of the deferred section 987 gain or loss.

Under the fresh start transition method of § 1.987-10(c)(4), on the transition date all qualified business units of the taxpayer subject to section 987 are deemed terminated on the last day of the taxable year preceding the transition date. As under the deferral transition method, this deemed termination is solely for purposes of transitioning to the foreign exchange exposure pool method under section 987 and does not apply for any other purpose. Under the fresh start transition method, no section 987 gain or loss is determined or recognized on such deemed termination. Rather, the exchange rates used to determine the total amount of assets and liabilities deemed transferred from the owner to the section 987 QBU for the section 987 QBU's first taxable year are determined solely with reference to the historic exchange rates on the day the assets were acquired or liabilities entered into

by the qualified business unit that was deemed terminated. Like the deferral transition method, if the taxpayer is not able to trace an exchange rate to a particular asset or liability, then the exchange rate must be determined under a reasonable allocation method, consistently applied, that takes into account the aggregate basis of the QBU's assets (and amount of liabilities). The fresh start method is designed to prevent recognition of non-economic currency gain or loss with respect to unremitted assets that are attributable to the qualified business unit. In the first taxable year when the foreign exchange exposure pool method applies, the deemed contribution of marked assets to a section 987 QBU at the historic exchange rate when originally acquired potentially gives rise to section 987 gain or loss while the historic assets (also translated at the historic exchange rate) will not.

The transition method adopted by the taxpayer must be disclosed in accordance with the rules provided in § 1.987-10(c)(6).

Proposed Effective Date

These regulations are proposed to be effective as follows. These regulations shall generally apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. A taxpayer may elect to apply these regulations to taxable years beginning after the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. Such election is binding on all members that file a consolidated return with the taxpayer and any controlled foreign corporation, as defined in section 957, in which the taxpayer owns more than 50 percent of the voting power or stock (as determined in section 957(a)). Pending finalization, the IRS and the Treasury Department would consider positions consistent with these proposed regulations to be reasonable constructions of the statute.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information contained in this regulation will not have a significant economic

impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The proposed section 987 regulations will generally only affect large United States corporations with business units operating in foreign jurisdictions. Thus, the number of affected small entities will not be substantial and any economic impact on those entities in complying with the collection of information would be minimal. Pursuant to section 7805(f) of the Internal Revenue Code, 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 businesses.

Comments and Public Hearing

Before the 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. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 21, 2006, beginning at 10 a.m. in the Auditorium, Internal Revenue Service, New Carrollton Federal Building, 5000 Ellin Road, Lanham, MD 20706. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit electronic or written comments by December 6, 2006 and an outline of the topics to be discussed and time to be devoted on each topic (a signed original and eight (8) copies) by October 31, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of the proposed regulations are Jeffrey Dorfman and Theodore Setzer of the Office of Associate Chief Counsel (International).

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-208270-86) that was published in the **Federal Register** on September 25, 1991 (56 FR 48457) is withdrawn.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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), 6601 and 7805 * * *

Par. 2. Section 1.861-9T is amended as follows:

1. Paragraph (g)(2)(ii)(A)(1) is revised.
2. Paragraph (g)(2)(vi) is added.

The revisions 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, the tax book value shall be determined by applying the rules of paragraphs (g)(2)(i) and (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 date.* Generally, paragraph (g)(2)(ii)(A)(1) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. If a taxpayer makes an election under § 1.987–11(b), then the effective date of paragraph (g)(2)(ii)(A)(1) of this section with respect to the taxpayer shall be consistent with such election.

* * * * *

Par. 3. Section 1.985–1 is amended as follows:

1. Paragraph (d)(2), second sentence; and paragraph (f), *Example 9* and *Example 10*(i), ninth sentence are revised.

2. Paragraph (f), *Example 11* is removed.

3. Paragraph (f), *Example 12* is redesignated as *Example 11*.

4. Paragraph (g) is added.

The revisions and addition read as follows:

§ 1.985–1 Functional currency.

* * * * *

(d) * * *

(2) * * * The amount of income or loss or earnings and profits (or deficit in earnings and profits) of each QBU in its functional currency shall then be translated into the foreign corporation's functional currency under the principles of section 987.

* * * * *

(f) *Examples.* * * *

Example (9). (i) The facts are the same as in *Example (7)*. In addition, assume that in 1987 branch A has items of earnings of 100 FC and branch B has items of earnings of 100 LC as determined under section 987. S translates branch A's and branch B's items of earnings and profits into its functional currency under the principles of section 987.

Example (10). (i) * * * Assume that B's items of income of 200 DCs when properly translated under the principles of section 987 is equal to 100 LCs. * * *

* * * * *

(g) *Effective date.* Generally, the revisions to the second sentence of paragraph (d)(2), *Example 9*, and *Example 10* shall apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. If a taxpayer makes an election under § 1.987–11(b), then the effective date of these revisions with respect to the taxpayer shall be consistent with such election.

Par 4. 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, qualified business unit (QBU) or 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, QBU, or section 987 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 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 or earnings and profits on the last day of the taxable year ending before the year of change. Except as provided in § 1.985–6, a QBU or section 987 QBU with a functional currency for its first taxable year beginning in 1987 that is different from the currency in which it had kept its books and records for United States accounting and tax accounting purposes for its prior taxable year shall apply the principles of this section for purposes of computing the relevant functional currency items, such as earnings and profits, basis of an asset, and amount of a liability, as of the first day of a taxpayer's first taxable year beginning in 1987. However, a QBU that changes to the dollar pursuant to § 1.985–1(b)(2) after 1987 shall apply § 1.985–7.

(b) *Step 1 Taking into account exchange gain or loss on certain section 988 transactions.* The taxpayer, QBU or section 987 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), (B), and (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 amount of the old functional currency adjusted basis or amount multiplied by the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change (spot rate).

(d) *Step 3A Additional adjustments that are necessary when a QBU or section 987 QBU changes functional currency—(1) QBU changing to a functional currency other than the owner's functional currency—(i) Rule.* If a QBU or section 987 QBU changes to a functional currency other than the owner's functional currency, the owner and section 987 QBU shall make the adjustments set forth in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section for purposes of section 987.

(ii) *Where prior to the change the section 987 QBU and owner had different functional currencies.* If the section 987 QBU and the owner had different functional currencies prior to the change, the owner and section 987 QBU shall make the following adjustments in the year of change.

(A) *Determining the owner functional currency net value of the section 987 QBU under § 1.987–4(d)(1)(i)(B)—(1) Historic items.* For purposes of determining the owner functional currency net value of the section 987 QBU for the year of change under § 1.987–4(d)(1)(i)(B), the owner or section 987 QBU shall first translate the section 987 historic items from the QBU's old functional currency into its owner's functional currency using the historic exchange rate as defined in § 1.987–1(c)(3). The owner or section 987 QBU shall then translate the section 987 historic items as defined in § 1.987–1(e) from the owner's functional currency into the QBU's new functional currency using the spot exchange rate between the section 987 QBU's new functional currency and the owner's functional currency on the last day of the taxable year ending before the year of change.

(2) *Marked items.* For purposes of determining the owner functional currency net value of the section 987 QBU for the year of change under § 1.987–4(d)(1)(i)(B), the owner or section 987 QBU shall translate the section 987 QBU's section 987 marked items as defined in § 1.987–1(d) from the section 987 QBU's old functional currency into the QBU's new functional

currency using the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change.

(B) *Net unrecognized section 987 gain or loss.* No adjustment to the owner's net unrecognized section 987 gain or loss is necessary.

(iii) *Where prior to the change the QBU and the taxpayer had the same functional currency.* If a QBU with the same functional currency of the taxpayer is changing to a new functional currency different from the taxpayer, and as a result of the change the taxpayer will be an owner of a section 987 QBU (see § 1.987-1), the taxpayer and section 987 QBU shall become subject to section 987 for the year of change and subsequent years.

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

(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 product of the old functional currency amounts of such items multiplied by the spot rate. 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. Such a shareholder shall also recognize gain or loss attributable to the corporation's paid-in capital to the same extent, if any, that such gain or loss would be recognized under the regulations under section 367(b) if the corporation was liquidated completely.

(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 changes to a functional currency that differs from the functional currency of its section 987 QBU, the owner shall make the following adjustments in the year of change.

(A) *Determining the owner functional currency net value of the section 987 QBU under § 1.987-4(d)(1)(i)(B)—(1) Historic items.* For purposes of determining the owner functional currency net value of the section 987 QBU for the year of change under § 1.987-4(d)(1)(i)(B), the owner shall first translate the QBU's section 987 historic items into the owner's old functional currency at the historic exchange rate as defined in § 1.987-1(c)(3). The owner shall then translate the section 987 historic items into its new functional currency using the new functional currency/old functional currency spot rate on the last day of the taxable year ending before the year of change.

(2) *Marked items.* For purposes of determining the owner functional

currency net value of the section 987 QBU for the year of change under § 1.987-4(d)(1)(i)(B), the owner or section 987 QBU shall translate the QBU's section 987 marked items from the owner's old functional currency into the owner's new functional currency using the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change.

(B) *Translation of net unrecognized section 987 gain or loss.* The owner shall translate any net unrecognized section 987 gain or loss determined under § 1.987-4 from its old functional currency into its new functional currency using the new functional currency/old functional currency spot exchange rate on the last day of the 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 of the change the taxpayer will be an owner of a section 987 QBU (see § 1.987-1), the taxpayer and 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 to the same functional currency as its section 987 QBU, such section 987 QBU shall be treated as if it terminated on last day of the taxable year ending before the year of change. See §§ 1.987-5 and 1.987-8 for the effect of a termination.

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

Example. S, a calendar year foreign corporation, is wholly owned by domestic corporation P. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. The LC/FC exchange rate on December 31, 1992, is 1 LC/2 FC. The following shows how S must convert the items on its balance sheet from the LC to the FC.

	LC ^{1 2}	FC
Assets:		
Cash on hand	40,000	80,000
Accounts Receivable	10,000	20,000
Inventory	100,000	200,000
100,000 FC Bond (100,000 LC historical basis)	¹ 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

	LC ^{1 2}	FC
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	² 50,000	100,000
Total Liabilities and Equity	1,300,000	2,600,000

¹ Under paragraph (b) of this section, S will recognize a 50,000 LC loss (100,000 LC basis—50,000 LC value) on the bond resulting from the change in functional currency. Thus, immediately before the change, S's basis in the FC bond (taking into account the loss) is 50,000 LC.

² The amount of S's LC retained earnings reflects the 50,000 LC loss on the bond.

(g) *Effective date.* Generally, this regulation shall apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. If a taxpayer makes an election under § 1.987-11(b), then the effective date of this regulation with respect to the taxpayer shall be consistent with such election.

Par. 5. Sections 1.987-1 through 1.987-4 and §§ 1.987-6 through 1.987-11 are added and § 1.987-5 is revised to read as follows:

§ 1.987-1 Scope, definitions and special rules.

(a) *In general.* These regulations provide rules for determining the taxable income or loss of a taxpayer with respect to a section 987 qualified business unit (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 and special rules. Section 1.987-2 provides rules for attributing assets and liabilities and items of income, gain, deduction, and loss to an eligible QBU and a section 987 QBU. It also provides rules regarding transfers and the translation of items transferred to a section 987 QBU. Section 1.987-3 provides rules for determining and translating the section 987 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. 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 partnerships and rules necessary to coordinate the provisions of section 987

with subchapter K. 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 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 (iii) of this section, an individual or corporation is subject to section 987 if such person is an owner (as defined in paragraphs (b)(4) and (5) 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). Such individual or corporation, and any section 987 QBU owned by such person, must comply with these regulations.

(ii) *De minimis rule for certain indirectly owned section 987 QBUs.* An individual or corporation that owns a section 987 QBU indirectly through a section 987 partnership may elect not to apply these regulations for purposes of taking into account the section 987 gain or loss of such section 987 QBU if the individual or corporation owns, directly or indirectly, less than five percent of either the total capital or the total profits interest in the section 987 partnership as determined on the date of acquisition of such interest or on the date such interest is increased or decreased. For purposes of this paragraph (b)(1)(ii), ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c), other than section 267(c)(3). See § 1.987-3 for purposes of determining the section 987 taxable income or loss attributable to such section 987 QBU.

(iii) *Inapplicability to certain entities.* These regulations do not apply to banks, insurance companies and similar financial entities (including, solely for

purposes of section 987, leasing companies, finance coordination centers, regulated investment companies and real estate investment trusts). Further, these rules do not apply to trusts, estates and S corporations.

(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 owner. The functional currency of an eligible QBU shall be determined under § 1.985-1, taking into account all of the QBU's activities before the application of § 1.987-7.

(ii) *Section 987 QBU grouping election—(A) In general.* Except as provided in paragraphs (b)(2)(ii)(B)(1) through (3) of this section, an owner may elect pursuant to paragraph (f) of this section to treat, solely for purposes of section 987, all section 987 QBUs with the same functional currency as a single section 987 QBU.

(B) *Special grouping rules for section 987 QBUs owned indirectly through a partnership—(1) In general.* An owner may elect to treat all section 987 QBUs with the same functional currency owned indirectly through a single section 987 partnership as a single section 987 QBU.

(2) *Election not available to group section 987 QBUs owned indirectly through different partnerships.* An owner cannot elect to treat multiple section 987 QBUs with the same functional currency as a single section 987 QBU if such QBUs are owned indirectly through different section 987 partnerships.

(3) *Election not available to group section 987 QBUs owned directly and indirectly.* An owner cannot elect to treat multiple section 987 QBUs with the same functional currency owned directly, and indirectly through a section 987 partnership, as a single section 987 QBU.

(3) *Definition of an eligible QBU—(i) In general.* The term *eligible QBU* means activities of an individual, corporation,

partnership, or an entity disregarded as an entity separate from its owner for U.S. Federal income tax purposes (DE), if—

(A) The activities constitute a trade or business as defined in § 1.989(a)–1(c);

(B) A separate set of books and records is maintained as defined in § 1.989(a)–1(d) with respect to the activities, and assets and liabilities used in conducting such activities are reflected on such books and records under § 1.987–2(b); and

(C) The activities are not subject to the Dollar Approximate Separate Transactions Method (DASTM) rules of § 1.985–3.

(ii) *Exclusion of DEs and certain QBUs.* A DE itself is not an eligible QBU (even though a DE may have activities that qualify as an eligible QBU). In addition, an eligible QBU shall include a QBU defined in § 1.989(a)–1(b) only if the requirements contained in paragraphs (b)(3)(i)(A) through (C) of this section are satisfied with respect to such QBU. Thus, for example, neither a corporation nor a partnership itself is an eligible QBU (even though a corporation and a partnership may have activities that qualify as an eligible QBU).

(4) *Definition of the term “owner”.* For purposes of section 987, only an individual or corporation may be an owner of an eligible QBU. An individual or corporation is an owner of an eligible QBU if—

(i) *Direct ownership.* The individual or corporation is the tax owner of the assets and liabilities of an eligible QBU as defined in paragraph (b)(3) of this section; or

(ii) *Indirect ownership.* In the case of an individual or corporation that is a partner in a partnership, the individual or corporation is allocated, under § 1.987–7, all or a portion of the assets and liabilities of an eligible QBU of such partnership.

(5) *Exception with respect to an eligible QBU or section 987 QBU of an owner.* The term *owner* for section 987 purposes does not include an eligible QBU or a section 987 QBU of an owner. For example, a section 987 branch, as defined in paragraph (b)(6)(i) of this section is not an owner of another section 987 branch, regardless of its functional currency.

(6) *Other definitions.* Solely for purposes of section 987, the following definitions shall apply.

(i) *Section 987 branch.* A section 987 branch is an eligible QBU of an individual, partnership, DE, or corporation, all or a portion of which is a section 987 QBU. Assets and liabilities of an eligible QBU of a partnership that are allocated to a partner under § 1.987–

7 are considered to be a section 987 QBU of such partner, provided such partner has a functional currency different from that of such eligible QBU.

(ii) *Section 987 partnership.* A section 987 partnership is a partnership that has one or more section 987 branches.

(iii) *Section 987 DE.* A section 987 DE is a DE that has one or more section 987 branches.

(7) *Examples.* The following examples illustrate the principles of paragraph (b) of this section. Except as otherwise provided, the following facts are assumed for purposes of these examples. X is a domestic corporation, has the U.S. dollar as its functional currency, and uses the calendar year as its taxable year. Business A and Business B are eligible QBUs, maintain books and records that are separate from the books and records of the entity that owns such eligible QBUs, and have the euro and the Japanese yen, respectively, as their functional currencies. Finally, DE1 and DE2 are entities that are disregarded as entities separate from their owner for U.S. tax purposes, have no assets or liabilities, and conduct no activities.

Example 1. (i) *Facts.* X owns Business A and the interests in DE1. DE1 maintains a separate set of books and records that are kept in British pounds. DE1 owns British pounds and 100% of the stock of a foreign corporation, FC. DE1 is liable on a pound-denominated obligation to a lender 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, X is the direct owner of Business A because it is the tax owner of the assets and liabilities of such business. Because Business A is an eligible QBU with a functional currency that is different from the functional currency of its owner, X, Business A is a section 987 QBU, as defined in paragraph (b)(2) of this section. As a result, X and its section 987 QBU, Business A, are subject to section 987.

(B) Holding the stock of FC and pounds, and servicing a single 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 is not an eligible QBU. As a result, neither DE1 nor its activities qualify as a section 987 QBU of X. Therefore, neither the activities of DE1 nor DE2 are subject to section 987. For the foreign currency treatment of payments on DE1's pound-denominated liability, see §§ 1.987–2(b)(4) and 1.988–1(a)(4).

Example 2. (i) *Facts.* X owns the interests in DE1. DE1 owns Business A and 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, X 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 X, Business A and Business B are section 987 QBUs as defined in paragraph (b)(2) of this section. Therefore, X, and these QBUs, are subject to section 987. Under paragraph (b)(6)(iii) of this section, DE1 and DE2 are section 987 DEs.

(C) The Business C eligible QBU has the same functional currency as X. Therefore, the Business C eligible QBU is not a section 987 QBU. As a result, X is not subject to section 987 with respect to its Business C eligible QBU.

Example 3. (i) *Facts.* X owns 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, X is the direct owner of the Business A and Business B eligible QBUs.

(B) Business A and Business B constitute two separate eligible QBUs with the euro as their respective functional currency. Accordingly, Business A and Business B are section 987 QBUs of X. X 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, X is the direct owner of the Business AB section 987 QBU that includes 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 is not treated as the owner of the Business AB section 987 QBU. X, and its AB section 987 QBU, are subject to section 987. Under paragraph (b)(6)(iii) of this section, DE1 is a section 987 DE.

Example 4. (i) *Facts.* X is a partner in P, a partnership. FC, a controlled foreign corporation (as defined in section 957(a)) of

X with the Japanese yen as its functional currency, is the only other partner in P. P owns DE1 and Business A. DE1 owns Business B.

(ii) *Analysis.* (A) Pursuant to paragraph (b)(3)(ii) of this section, P and DE1 are not eligible section 987 QBUs. Moreover, pursuant to paragraph (b)(4) of this section, neither P nor DE1 is the owner of the Business A eligible QBU or the Business B eligible QBU for section 987 purposes. Instead, pursuant to paragraph (b)(4)(ii) of this section, X and FC are indirect owners of the Business A eligible QBU and the Business B eligible QBU to the extent they are allocated assets and liabilities of such businesses under § 1.987-7. Under paragraphs (b)(6)(ii) and (iii) of this section, respectively, P is a section 987 partnership and DE1 is a section 987 DE.

(B) Because Business A and Business B are eligible QBUs with a different functional currency than X, the portions of Business A and Business B allocated to X under § 1.987-7 are section 987 QBUs of X. As a result, X and its section 987 QBUs are subject to section 987.

(C) Because the Business A eligible QBU has a different functional currency than FC, the portion of the Business A eligible QBU that is allocated to FC under § 1.987-7 is a section 987 QBU, and FC and its section 987 QBU are subject to section 987. However, the Business B eligible QBU has the same functional currency as FC. Therefore, the portion of the Business B eligible QBU that is allocated to FC, under § 1.987-7, is not a section 987 QBU. As a result, FC is not subject to section 987 with respect to its Business B eligible QBU.

Example 5. (i) *Facts.* X owns all of the interests in DE1. DE1 owns Business A. DE1 owns all of the interests in DE2. DE2 owns Business B. DE2 owns 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 (b)(3)(ii) of this section, DE1, DE2 and DE3 are not eligible QBUs. Pursuant to paragraph (b)(3)(i) of this section, the Business A, Business B and Business C activities are eligible QBUs. Moreover, pursuant to paragraph (b)(4) of this section, X is the direct owner of the Business A, Business B and Business C eligible QBUs. Pursuant to paragraph (b)(5) 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. Since the Business A, Business B, and Business C eligible QBUs each has a different functional currency than X, such eligible QBUs are section 987 QBUs of X. As a result, X and its section 987 QBUs are subject to section 987. Under paragraphs (b)(6)(iii) of this section, DE1, DE2 and DE3 are section 987 DEs.

(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 day.

(ii) *Election to use a spot rate convention*—(A) *In general.* In lieu of the spot rate determined in paragraph (c)(1)(i) of this section, an owner may elect under paragraph (f) of this section to use a spot rate convention that reasonably approximates the rate in paragraph (c)(1)(i) of this section. A spot rate convention may be determined with respect to a rate at the beginning of a reasonable period, the end of a reasonable period, an average of spot rates for a reasonable period, or by reference to spot and forward rates for a reasonable period. 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 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 owner's 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 use of such a convention results in a significant distortion of income or loss under the facts and circumstances.

(B) *Election does not apply with respect to section 988 transactions.* The election to use a spot rate convention set forth in paragraph (c)(1)(ii)(A) of this section does not apply to section 988 transactions of a section 987 QBU.

(2) *Yearly average exchange rate.* Notwithstanding § 1.989(b)-1, for purposes of section 987, the yearly average exchange rate is a rate determined by the owner that represents an average exchange rate for the taxable year (or, if the section 987 QBU is sold or terminated prior to the close of the 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. The method

for determining the yearly average exchange rate must be consistently applied by the taxpayer.

(3) *Historic exchange rate*—(i) *In general.* Except as otherwise provided in these regulations, the historic exchange rate shall be—

(A) In the case of an asset that is transferred to a section 987 QBU, the spot rate as defined in paragraphs (c)(1)(i) and (ii) of this section on the day of transfer;

(B) In the case of an asset that is acquired by a section 987 QBU (other than by a transfer to a section 987 QBU described in paragraph (c)(3)(i)(A) of this section), the spot rate as defined in paragraphs (c)(1)(i) and (ii) of this section on the day the asset is acquired;

(C) In the case of a liability that is entered into by a section 987 QBU, the spot rate as defined in paragraphs (c)(1)(i) and (ii) of this section on the day the liability is entered into; and

(D) In the case of a liability that is transferred to a section 987 QBU, the spot rate as defined in paragraphs (c)(1)(i) and (ii) of this section on the day the liability is transferred.

(ii) *Changed functional currency.* In the case of a section 987 QBU that previously changed its functional currency, § 1.985-5 shall be taken into account in determining the historic exchange rate for an item.

(d) *Section 987 marked item.* A section 987 marked item is an asset (section 987 marked asset) or liability (section 987 marked liability) that—

(1) Is reflected on the books and records of a section 987 QBU under § 1.987-2(b);

(2) Would be a section 988 transaction if such item were held or entered into directly by the owner of the section 987 QBU; and

(3) Is not a section 988 transaction with respect to the section 987 QBU.

(e) *Section 987 historic item*—(1) *In general.* A section 987 historic item is an asset (section 987 historic asset) or liability (section 987 historic liability) that—

(i) Is reflected on the books and records of a section 987 QBU under § 1.987-2(b); and

(ii) Is not a section 987 marked item as defined in paragraph (d) of this section.

(2) *Example.* The following example illustrates the application of paragraphs (d) and (e) of this section:

Example. X is a domestic corporation with the dollar as its functional currency. X owns all the interests in UK DE, a section 987 DE that owns a section 987 branch having the pound as its functional currency. Items reflected on the branch's balance sheet include £100 of cash, \$25 of cash, a building

with a basis of £1,000, a truck with a basis of £75, a computer with a basis of £10, a 60 day receivable for ¥15 and a note payable of £500. Under paragraph (d) of this section, the £100 of cash and the £500 note payable are section 987 marked items. The other items are section 987 historic items under this paragraph (e).

(f) *Elections*—(1) *In general.* Elections made under section 987 shall be treated as methods of accounting and, except as otherwise provided in this paragraph (f), are governed by the general rules concerning changes in methods of accounting.

(2) *Persons making the election*—(i) *In general.* Except as provided in paragraphs (f)(2)(ii) and (iii) of this section, elections regarding section 987 shall be made by the owner as defined in paragraph (b)(4) of this section.

(ii) *Controlled foreign corporations.* Where a section 987 QBU is held by a controlled foreign corporation, elections shall be made in accordance with §§ 1.952-2(c)(2)(iv) and 1.964-1(c) by its controlling U.S. shareholders.

(iii) *Foreign corporations that are not controlled foreign corporations.* Where a section 987 QBU is held by a foreign corporation that is not a controlled foreign corporation, elections shall be made in accordance with the principles of § 1.964-1(c) by the majority domestic corporate shareholders.

(3) *When elections must be made.* An election under section 987 must be made with respect to a section 987 QBU 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.

(4) *Manner of making elections.* Elections shall be made under section 987 by attaching a statement to the timely filed tax return of the owner, or other applicable person, for the first taxable year in which the owner intends the election to be effective. The statement must be dated and titled “Election(s) Under Section 987,” must indicate the regulation section that authorizes the election(s), and must clearly describe the election(s) being made. Each section 987 election must remain a part of the books and records of the taxpayer and be available to the IRS upon request.

(5) *Consent of the Commissioner.* Elections made in accordance with the rules of this paragraph (f) shall be considered made with the consent of the Commissioner.

(6) *Failure to make election.* If an owner is permitted to file an election pursuant to this paragraph (f), but fails to make such election in a timely manner, the owner shall be considered

to have satisfied the timeliness requirement with respect to such election if the owner is able to demonstrate to the Area Director, Field Examination, Small Business/Self Employed or the Director, Field Operations, Large and Mid-Size Business (Director) having jurisdiction of the taxpayer’s return for the taxable year, that such failure was due to reasonable cause and not willful neglect. The previous sentence shall only apply if, once the owner becomes aware of the failure, the owner attaches the election, as well as a written statement setting forth the reasons for the failure to timely comply, to an amended income tax return that amends the return to which the election should have been attached under the rules of this paragraph (f). In determining whether the owner has reasonable cause, the Director shall consider whether the taxpayer acted reasonably and in good faith. Whether the taxpayer acted reasonably and in good faith will be determined after considering all the facts and circumstances. The Director shall notify the owner in writing within 120 days of the filing if it is determined that the failure to comply was not due to reasonable cause, or if additional time will be needed to make such determination. If the Director fails to notify the owner within 120 days of the filing, the owner shall be considered to have demonstrated to the Director that such failure was due to reasonable cause and not willful neglect.

(7) *Revocation of election*—(i) *In general.* Elections under section 987 cannot be revoked without the consent of the Commissioner. The Commissioner will consider allowing the revocation of an election if the taxpayer can demonstrate significantly changed circumstance or such other circumstances that in the judgment of the Commissioner clearly demonstrates a substantial non-tax business reason for revoking the election.

(ii) *Exception in the case of certain acquisitions.* [Reserved].

§ 1.987-2 Attribution of items to a section 987 QBU; the 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 and a section 987 QBU. Assets and liabilities are attributed to an eligible QBU, all or a portion of which is a section 987 QBU for purposes of section 987. Items of income, gain, deduction, and loss are attributed to an eligible QBU all or a portion of which is a

section 987 QBU for purposes of computing the section 987 taxable income of such section 987 QBU, and of the owner of such section 987 QBU. Paragraph (c) of this section defines a transfer for purposes of section 987. 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. For purposes of this section, the term “item” refers to assets and liabilities, and items of income, gain, deduction, and loss. Items that are attributed to an eligible QBU pursuant to this section must be adjusted to conform to U.S. tax principles as provided in § 1.987-4(e). 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*—(i) *General rule.* Except as provided in paragraph (b)(2)(ii) of this section, the following shall not be considered to be on the books and records of a an eligible QBU:

(A) Stock of a corporation (whether domestic or foreign).

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

(C) A liability that was incurred to acquire the stock or an interest in a partnership described in paragraphs (b)(2)(i)(A) or (B) of this section, respectively.

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

(ii) *Portfolio stock.* Paragraph (b)(2)(i)(A) of this section shall not apply to stock of a corporation (whether domestic or foreign) reflected on the books and records, within the meaning of paragraph (b)(1) of this section, of an eligible QBU provided the owner of the eligible QBU owns less than 10 percent of the total voting power or value of all classes of stock of such corporation. For purposes of this paragraph (b)(2)(ii), section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase

“10 percent” is used instead of the phrase “50 percent.”

(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 U.S. tax under section 987, the Commissioner may allocate any item between or among the eligible QBU, the owner of such eligible QBU, and any other persons, entities (including disregarded entities), or other QBUs within the meaning of § 1.989(a)–1(b) (including eligible QBUs). A transaction may have such a principal purpose even though the tax avoidance purpose is outweighed by other purposes when taken together. For purposes of this paragraph (b)(3)(i), relevant factors for determining whether such U.S. 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 of a particular number of 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, relevant factors which may indicate that the recording (or failing to record) an item on the books and records of an eligible QBU does not have as a principal purpose the avoidance of U.S. tax under 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 body of professional accounting standards).

(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 return for the taxable year.

(G) As a result of a transaction between legal entities (that is, the transfer of an asset, or the assumption of a liability), even if such transaction

is not regarded for Federal tax purposes (that is, a transaction between a DE and its owner).

(iii) *Factors indicating tax avoidance.* For purposes of paragraph (b)(3)(i) of this section, relevant factors which 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 U.S. tax under section 987 are—

(A) The presence or absence of an item on the books and records that is disregarded as transitory 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 economic substance;

(C) The presence or absence of an item on the books and records that results in the taxpayer (or 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; and

(D) The absence of any or all of the factors listed in paragraphs (b)(3)(ii)(A) through (E) of this section.

(4) *Assets and liabilities of a partnership or DE that are not attributed to an eligible QBU.* Neither a partnership nor a DE is an eligible QBU and, thus, cannot be a section 987 QBU. See § 1.987–1(b)(2) and (3). As a result, a partnership or DE may own assets and liabilities that are not attributed to an eligible QBU (or a section 987 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 the owner to a section 987 QBU, or from such section 987 QBU to the owner. These rules apply solely for purposes of section 987.

(2) *Disregarded transactions*—(i) *General rule.* Solely for purposes of section 987, an asset or liability shall be treated as transferred to a section 987 QBU if, as a result of a disregarded transaction, 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 if, as a result of a disregarded transaction, such asset or liability is not 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, the term *disregarded transaction* means a transaction that is not regarded for U.S. Federal tax purposes. For purposes of this paragraph (c), a disregarded transaction shall be treated as including the recording of an asset or liability on one set of books and records, if the recording is the result of such asset or liability being removed from another set of books and records of the same person or entity (including a DE or partnership).

(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 must be taken into account in determining section 987 taxable income or loss under § 1.987–3.

(3) *Transfers of assets to and from indirectly owned section 987 QBUs*—(i) *Contributions to partnerships.* Solely for purposes of section 987, an asset shall be treated as transferred to an indirectly owned section 987 QBU if, and to the extent, the asset is contributed to the section 987 partnership that carries on the section 987 QBU provided that immediately following such contribution, the asset is reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section. For purposes of this paragraph (c)(3)(i), deemed contributions under section 752 shall be disregarded.

(ii) *Distributions from partnerships.* Solely for purposes of section 987, an asset shall be treated as transferred from an indirectly owned section 987 QBU if, and to the extent, the section 987 partnership that carries on the section 987 QBU distributes the asset to a partner provided that, immediately prior to such distribution, the asset was reflected on the books and records of such section 987 QBU within the meaning of paragraph (b) of this section. For purposes of this paragraph (c)(3)(ii), deemed distributions under section 752 shall be disregarded.

(4) *Transfers of liabilities to and from indirectly owned section 987 QBUs*—(i) *Assumptions of partner liabilities.* Solely for purposes of section 987, a liability shall be treated as transferred to an indirectly owned section 987 QBU if, and to the extent, the section 987 partnership assumes such liability, provided that immediately following 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.

(ii) *Assumptions of partnership liabilities.* Solely for purposes of section 987, a liability shall be treated as transferred from an indirectly owned

section 987 QBU if, and to the extent, the owner assumes such liability of the section 987 partnership provided that immediately prior to such assumption, the liability was reflected on the books and records of the section 987 QBU within the meaning of paragraph (b) of this section.

(5) *Acquisitions and dispositions of interests in DEs and partnerships.* Solely for purposes of section 987, an asset or liability shall be treated as transferred to a section 987 QBU if, as a result of an acquisition (including by contribution) or disposition of an interest in a section 987 partnership or section 987 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 if, as a result of an acquisition or disposition of an interest in a section 987 partnership or section 987 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 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 with respect to an eligible QBU that causes a direct owner of the eligible QBU to become an indirect owner of such 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), see § 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, and substance-over-form doctrines, apply for purposes of determining whether there is a transfer of an asset or liability under this paragraph (c).

(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) *Examples.* The following examples illustrate the principles of this paragraph (c). For purposes of these examples, it is assumed that X and Y are domestic corporations, have the dollar as their functional currency, and use the calendar year as their taxable year. It is also assumed that Business A and Business B are eligible QBUs, maintain books and records that are separate from

the books and records of the entity that owns such eligible QBUs, and have the euro and the yen, respectively, as their functional currencies. Finally, it is assumed that DE1 and DE2 are entities that are disregarded as entities separate from their owner for U.S. tax purposes. 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 100 percent of the interests in DE1. DE1 owns Business A. 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 loans the £100 to DE1 (to be used in Business A) in exchange for a note.

(ii) *Analysis.* (A) The loan from X to DE1 is not regarded for U.S. federal tax purposes and therefore is a disregarded transaction. As a result, the Business A note held by X, and the liability of DE1 under the note, are not taken into account under this section. However, the £100 of cash that was loaned from X to DE1 (and used in Business A) pursuant to the note must be taken into account under this paragraph (c).

(B) The loan of €100 from X to DE1 is a disregarded transaction and, as a result of such disregarded transaction, the €100 is reflected on the books and records of Business A. Therefore, there has been a transfer of €100 from X to Business A. See § 1.988-1(a)(10)(ii) for the application of section 988 to X as a result of the loan.

Example 2. Transfer to a directly owned section 987 QBU. (i) *Facts.* X owns Business A and Business B. 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 discontinues being used in Business A and begins being used in Business B. As a result of such equipment being used by Business B, 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.* As a result of Business B using the equipment formerly used by Business A, 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. As a result, such entries constitute a disregarded transaction. Therefore, there has been a transfer of the equipment from the Business A section 987 QBU to X, and a transfer by X of such equipment to the Business B section 987 QBU.

Example 3. Intercompany sale of property between two section 987 QBUs. (i) *Facts.* X owns DE1 and DE2. DE1 and DE2 own Business A and Business B, respectively. 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 for cash. The cash 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 cash and 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 cash 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 not regarded for Federal tax purposes and therefore is a disregarded transaction. As a result, such sale is not taken into account under this section and does not give rise to an item of income, gain, deduction or loss pursuant to paragraph (c)(2)(iii) of this section. However, the cash and equipment exchanged by DE1 and DE2 in connection with the sale must be taken into account under this paragraph (c).

(B) The sale of the equipment is a disregarded transaction and, as a result of such 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, there has been a transfer of the equipment from DE1's Business A section 987 QBU owned by X to X, and a subsequent transfer of such equipment from X to DE2's Business B section 987 QBU, owned by X.

(C) As a result of the sale of equipment (that is, the disregarded transaction), the cash proceeds cease to be reflected on the books and records of Business B, and become reflected on the books and records of Business A. Therefore, there has been a transfer of the cash from DE2's Business B section 987 QBU owned by X to X, and a subsequent transfer of such cash from X to DE1's Business A section 987 QBU, owned by X.

Example 4. Transactions between directly and indirectly owned section 987 QBUs. (i) *Facts.* X owns 50% of the interest in P, a partnership. Y owns the other 50% interest in P. P owns 100% of the interests in DE1 and DE2. DE1 owns Business A and DE2 owns Business B. X and Y each have a 50% allocable share of the assets and liabilities of Business A and Business B, as determined under § 1.987-7, that constitute section 987 QBUs. 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). DE2 uses the intangible property in Business B. Pursuant to the license agreement, X and DE2 pay a €30 and €50 royalty, respectively, to DE1.

(ii) *Analysis.* (A) The license from DE2 to DE1 is not regarded for U.S. tax purposes and, as a result, royalty payments under the license are disregarded transactions. Thus, neither the payment nor the receipt of the royalty pursuant to the license agreement gives rise to an item of income, gain, deduction or loss pursuant to paragraph (c)(2)(iii) of this section. However, the €50 of cash that is paid from DE2 to DE1 pursuant to the license agreement must be taken into account under this paragraph (c).

(B) As a result of the royalty payment from DE2 to DE1, €50 ceases being reflected on the books and records of Business B, and becomes reflected on the books and records of Business A. Accordingly, there has been a transfer of €25 from the Business B section 987 QBUs of X and Y, to X and Y, respectively. Similarly, there has been a transfer of €25 from X and Y to their respective Business A section 987 QBUs.

(C) The €30 royalty payment from X to DE1 is not a disregarded transaction because it is regarded for U.S. Federal tax purposes. As a result, it gives rise to an item of income and deduction that must be taken into account in computing taxable income or loss of Business A pursuant to § 1.987-3. In addition, the payment does not give rise to a transfer as defined in this paragraph (c).

Example 5. Acquisition of an interest in a partnership. (i) *Facts.* X owns 50% of the interest in P, a partnership. Y owns the other 50% interest in P. P owns Business A. X and Y each have a 50% allocable share of the assets and liabilities of Business A as determined under § 1.987-7, that constitute section 987 QBUs. On December 31, year 1, Z, a domestic corporation with the dollar as its functional currency, contributes cash to P in exchange for a 20% interest in P. The cash Z contributes to P is not used in Business A and is not reflected on Business A's books and records (but is instead reflected on P's books and records). Immediately after Z's contribution of cash to P, Z has a 20% allocable share of the assets and liabilities of Business A as determined under § 1.987-7. In addition, immediately following such contribution X and Y each own a 40% interest in P and have a 40% allocable share of the assets and liabilities of Business A, as determined under § 1.987-7, that constitute section 987 QBUs.

(ii) *Analysis.* (A) As a result of Z's acquisition of an interest in P, a section 987 partnership, 10% of the assets and liabilities of Business A ceased being reflected on the books and records of both X's and Y's section 987 QBUs. As a result, such amounts are treated as if they are transferred from such section 987 QBUs to X and Y.

(B) As a result of Z's acquisition of the interest in P, a section 987 partnership, Z was allocated 20% of the assets and liabilities of Business A. Because Z and Business A have different functional currencies, Z's portion of the Business A assets and liabilities constitutes a section 987 QBU. Moreover, 20% of the assets and liabilities of Business A are reflected on the books and records of Z's section 987 QBU as a result of Z's acquisition of the interest in P. Therefore, 20% of the assets and liabilities of Business A are treated as transferred from Z to Z's section 987 QBU.

Example 6. Conversion of a DE to a partnership through a sale of an interest. (i) *Facts.* X owns 100% of the interests in DE1. DE1 owns Business A. On December 31, year 1, Y acquires 50% of the DE1 interests from X for cash. Immediately after such acquisition, Y has a 50% allocable share of the assets and liabilities of Business A as determined under § 1.987-7.

(ii) *Analysis.* (A) For Federal tax purposes DE1 is converted to a partnership when Y

purchases the 50% interest in DE1. Y's purchase of 50% of X's interest in DE1 is treated as the purchase of 50% of Business A, which is treated as held directly by X for Federal tax purposes. Immediately after the deemed purchase of 50% of Business A, X and Y are treated as contributing their respective interests in Business A to a partnership. See Rev. Rul. 99-5 (situation 1), (1999-1 CB 434). See § 601.601(d)(2) of this chapter. For purposes of this paragraph (c), these deemed transactions are not taken into account.

(B) As a result of Y's acquisition of 50% of X's interest in DE1, a section 987 DE, 50% of the assets and liabilities of Business A ceased being reflected on the books and records of X's section 987 QBU. As a result, such amounts are treated as if they are transferred from X's section 987 QBU to X.

(C) As a result of Y's acquisition of 50% of the interest in DE1, a section 987 DE, Y was allocated 50% of the assets and liabilities of Business A. Because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities constitutes a section 987 QBU. Moreover, 50% of the assets and liabilities of Business A are reflected on the books and records of Y's section 987 QBU as a result of Y's acquisition of the 50% interest in DE1. Therefore, 50% of the assets and liabilities of Business A are treated as transferred by Y to Y's section 987 QBU.

Example 7. Conversion of a DE to a partnership through a contribution. (i) *Facts.* X owns 100% of the interests in DE1. DE1 owns Business A. On December 31, year 1, Y contributes property 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. Immediately after such contribution, X and Y each have a 50% allocable share of the assets and liabilities of Business A as determined under § 1.987-7.

(ii) *Analysis.* (A) For Federal tax purposes DE1 is converted to a partnership when Y contributes property to DE1 in exchange for a 50% interest in DE1. 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). See § 601.601(d)(2) of this chapter. For purposes of this paragraph (c), these deemed transactions are not taken into account.

(B) As a result of Y's acquisition of a 50% interest in DE1, 50% of the assets and liabilities of Business A ceased being reflected on the books and records of X's section 987 QBU, and 50% of the assets contributed by Y to DE1 are reflected on the books and records of such section 987 QBU. As a result, 50% of the Business A assets are treated as if they are transferred from X's section 987 QBU to X. Further, 50% of the assets contributed by Y to DE1 are treated as if they are transferred by X to X's section 987 QBU.

(C) Because Y and Business A have different functional currencies, Y's portion of the Business A assets and liabilities (including the property contributed by Y that

is used in Business A) constitutes a section 987 QBU. As a result of Y's acquisition of a 50% interest in DE1, 50% of the assets and liabilities of Business A are reflected on the books and records of Y's section 987 QBU and, therefore, are treated as if they are transferred by Y to such section 987 QBU.

Example 8. Termination of a partnership under section 708(b). (i) *Facts.* X owns 60% of the interest in P, a partnership. Y owns the other 40% interest in P. P owns Business A. X and Y have a 60% and 40% allocable share of the assets and liabilities of Business A, respectively, as determined under § 1.987-7, that constitute section 987 QBUs. On December 31, year 1, X sells a 50% interest in P to Y. After such sale, X and Y own 10% and 90%, respectively, in P. In addition, after such sale, X and Y have a 10% and 90% allocable share of the assets and liabilities of Business A, respectively, as determined under § 1.987-7.

(ii) *Analysis.* (A) X's sale of 50% of the interests in P to Y causes P to terminate pursuant to section 708(b). As a result of such termination, P is treated as if it contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, P distributes 10% and 90% of the interests in the new partnership to X and Y, respectively, in liquidation of P. See § 1.708-1(b)(4). For purposes of this paragraph (c), these deemed transactions are not taken into account.

(B) As a result of Y's acquisition of a 50% interest in P from X, 50% of the assets and liabilities of Business A ceased being reflected on the books and records of X's section 987 QBU and become reflected on the books and records of Y's section 987 QBU. As a result, 50% of the Business A assets are treated as if they are transferred from X's section 987 QBU to X. Further, 50% of the Business A assets are treated as if they are transferred by Y to Y's section 987 QBU.

Example 9. Transfer of section 987 QBU to a partnership. (i) *Facts.* X owns Business A. On December 31, year 1, X and Y form P, a partnership. X transfers Business A to P in exchange for a 50% interest in P. Y transfers property to P in exchange for the other 50% interest in P. The property Y transfers to P is not used in Business A and is not reflected on the books and records of Business A (but is instead reflected on the books and records of P). After the formation of P, Business A continues to be an eligible QBU. In addition, after the formation of P, X and Y each have a 50% allocable share of the assets and liabilities of Business A, respectively, as determined under § 1.987-7.

(ii) *Analysis.* As a result of X contributing Business A to P, 50% of the assets and liabilities of Business A ceased being reflected on the books and records of X's section 987 QBU, and became reflected on the books and records of Y's section 987 QBU. As a result, 50% of the Business A assets are treated as if they are transferred from X's section 987 QBU to X. Further, 50% of the Business A assets are treated as if they are transferred from Y to Y's section 987 QBU.

Example 10. Contribution of assets to a corporation. (i) *Facts.* X owns Business A. On

December 31, year 1, X forms Z, a domestic corporation. X and Z do not file a consolidated tax return. X contributes 50% of its Business A assets and liabilities to Z in exchange for 100% of the stock of Z. The Z stock is recorded on the books and records of Business A. After the contribution, X continues to operate Business A, and Business A continues to maintain separate books and records from X.

(ii) *Analysis.* Even though the Z stock is recorded on the books and records of Business A, it is not reflected on the books and records for purposes of section 987 pursuant to paragraph (b)(2) of this section. As a result, there has been a transfer of 50% of the assets and liabilities of Business A to X, and a subsequent transfer of such assets and liabilities to Z. The answer would be the same even if X and Z filed a consolidated return.

Example 11. Transfers pursuant to general tax principles. (i) *Facts.* X owns 100 percent of the stock of Y. Y owns 100 percent of the interests in DE1. DE1 owns Business A. X owns €100. Because Business A is in need of additional capital, X transfers the €100 to Y as a contribution to capital and, as a result of such transfer, Business A records €100 on its separate books and records. Y did not record the €100 on its separate books and records.

(ii) *Analysis.* As a result of the contribution of €100 from X to Y, the €100 is reflected on the books and records of Business A. Pursuant to paragraph (c)(7) of this section, the €100 is treated as if it was transferred first from X to Y. Therefore, the €100 recorded on the books and records of Business A is treated as a transfer from Y to Business A, even though there was no transaction between Y and Business A. See also § 1.988-1(a)(10)(ii) for the application of section 988 to Y as a result of the transaction.

Example 12. Circular transfers. (i) *Facts.* X owns Business A. On December 30, year 1, Business A purports to transfer €100 to X. On January 2, year 2, X purports to transfer €50 to Business A. On January 4, year 2, X purports to transfer another €50 to Business A. As of the end of year 1, 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 transfers by Business A are offset by a transfer from X that occurred in close temporal proximity, pursuant to paragraph (c) of this section, the IRS will scrutinize the transaction and may disregard the purported transfers to and from Business A for purposes of section 987.

Example 13. Transfers without economic substance. (i) *Facts.* X owns Business A and Business B. On January 1, year 1, Business A purports to transfer €100 to X. On January 4, year 1, 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 year 1, 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,

pursuant to paragraph (c) of this section, the IRS will scrutinize the transaction and may disregard the €100 purported transfer from Business A to X for purposes of section 987.

Example 14. Offsetting positions in section 987 QBUs. (i) *Facts.* X owns Business A and Business B. Business A and Business B each has the euro as its functional currency. X has not made a grouping election under § 1.987-1(b)(2)(ii). On January 1, year 1, X borrowed €1,000 from a third party lender, recorded the liability with respect to the borrowing on the books and records of Business A, and recorded the €1,000 of borrowed cash on the books and records of Business B. On December 31, year 2, 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 cash, 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 to determine if a principal purpose of recording the euro-denominated liability and the borrowed euros on the books and records of Business A and Business B, respectively, 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, Business B, and X, to reflect the economic substance of the transaction.

Example 15. Offsetting positions with respect to a section 987 QBU and a section 988 transaction. (i) *Facts.* X owns DE1, and DE1 owns Business A. On January 1, year 1, 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, year 2, when Business A has \$100 of net unrecognized section 987 loss resulting from the €1,000 cash received from the borrowing, and 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 Internal Revenue Service will scrutinize the transaction 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 to reflect the economic substance of the transaction.

(d) *Translation of items transferred to a section 987 QBU—(1) In general—(i) Assets.* Except as otherwise provided in this section, the adjusted basis of an asset 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)(i) and (ii) on the day of transfer. If the asset transferred is denominated in (or determined by reference to) the functional currency of the section 987 QBU (for example, cash or note denominated in the functional currency of the section 987 QBU), no translation is required.

(ii) *Liabilities.* Except as otherwise provided in this section, a liability of the owner that is 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)(i) and (ii)) on the day of transfer. If the liability transferred is denominated in (or determined by reference to) the functional currency of the section 987 QBU, no translation is required.

(2) *Items denominated in the owner's functional currency.* Transactions described in section 988(c)(1)(i) and (ii) and section 988(c)(1)(C) that are denominated in (or determined by reference to) the owner's functional currency and that are attributable to a section 987 QBU under paragraph (b) of this section, shall not be translated and shall be carried on the balance sheet described in § 1.987-4(e) in the owner's functional currency.

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

(a) *Determination of the section 987 taxable income or loss of an owner of a section 987 QBU.* Except as otherwise provided in this section, the section 987 taxable income or loss of an owner with respect to a section 987 QBU shall be determined in accordance with paragraphs (a)(1) and (a)(2) of this section.

(1) *In general—(i) Determination of each item of income, gain, deduction or loss in the section 987 QBU's functional currency.* Except as otherwise provided in this section, the section 987 QBU shall determine each item of income, gain, deduction or loss attributable to such QBU under § 1.987-2(b) in its functional currency under U.S. tax principles.

(ii) *Translation of items into the owner's functional currency.* The owner shall translate each item determined under this paragraph (a)(1) into its functional currency as provided in paragraph (b) of this section.

(2) *Determination in the case of a section 987 QBU owned indirectly through a partnership—(i) In general.* Except as otherwise provided in this paragraph (a)(2), the taxable income or loss of a section 987 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 this chapter.

(ii) *Determination of each item of income, gain, deduction or loss in the eligible QBU's functional currency.*

Except as otherwise provided in this section, the section 987 partnership 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.* The section 987 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 this chapter.

(iv) *Translation of items into the owner's functional currency.* To the extent such items are reflected on the books and records of a section 987 QBU of a partner to whom they are allocated, the partner shall adjust the items to conform to U.S. tax principles and translate the items into the partner's functional currency as provided in paragraph (b) of this section.

(b) *Exchange rates to be used in translating 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 of a section 987 QBU as determined in § 1.987-2(b) into the owner's functional currency shall be the yearly average exchange rate as defined in § 1.987-1(c)(2) for the taxable year. Alternatively, the owner may elect under § 1.987-1(f) to use the spot rate as defined in § 1.987-1(c)(1)(i) and (ii) for the day each item is properly taken into account.

(2) *Exceptions—(i) Depreciation, depletion, and amortization deductions.* The exchange rate to be used by the owner in translating deductions allowable with respect to section 987 historic assets (as defined in § 1.987-1(e)) for depreciation, depletion, and amortization under the pertinent provisions of the Code shall be the historic exchange rate as determined under § 1.987-1(c)(3) for the property to which such deductions are attributable.

(ii) *Gain or loss from the sale of property.* In the case of gain or loss recognized on a sale or other disposition of property that is reflected on the books and records of a section 987 QBU during

the taxable year, the following exchange rates shall apply with respect to such sale or other disposition:

(A) *Amount realized—(1) In general.* Except as otherwise provided in paragraph (b)(2)(ii)(A)(2), the exchange rate to be used in translating the amount realized of such property shall be the rate provided in paragraph (b)(1) of this section for the taxable year.

(2) *Certain section 987 marked assets.* In the case of a section 987 marked asset (other than cash) that was held on the first day of the taxable year, the exchange rate to be used in translating the amount realized shall be the rate used for such asset in determining the owner functional currency net value of the section 987 QBU under § 1.987-4(d)(1)(i)(B) for the preceding taxable year. However, in the case of a section 987 marked asset (other than cash) transferred to the section 987 QBU or acquired by the section 987 QBU during the taxable year, the exchange rate to be used in translating the amount realized shall be the spot rate, as defined in § 1.987-1(c)(1)(i) and (ii), for the day transferred or acquired.

(B) *Adjusted basis—(1) In general.* Except as otherwise provided in paragraph (b)(2)(ii)(B)(2), the exchange rate to be used in translating the adjusted basis of such property shall be the historic exchange rate as determined under § 1.987-1(c)(3) for such asset.

(2) *Certain section 987 marked assets.* In the case of a section 987 marked asset (other than cash) that was held on the first day of the taxable year, the exchange rate to be used in translating its adjusted basis shall be the rate used for such asset in determining the owner functional currency net value of the section 987 QBU under § 1.987-4(d)(1)(i)(B) for the preceding taxable year. However, in the case of a section 987 marked asset (other than cash) transferred to the section 987 QBU or acquired by the section 987 QBU during the taxable year, the exchange rate to be used in translating the adjusted basis of such asset shall be the spot rate, as defined in § 1.987-1(c)(1)(i) and (ii), for the day transferred or acquired.

(3) *Gain or loss on the sale, exchange or other disposition of an interest in a section 987 partnership.* For purposes of determining the adjusted basis of a partner's interest in a section 987 partnership and computing gain or loss recognized on the sale, exchange or other disposition of such interest, see § 1.987-7.

(c) *Items of income, gain, deduction or loss that are denominated in the functional currency of the owner.* An item of income, gain, deduction or loss attributable to a section 987 QBU under

§ 1.987-2(b) that is denominated in (or determined by reference to) the owner's functional currency shall not be translated and shall be taken into account by the section 987 QBU under U.S. tax principles in the owner's functional currency.

(d) *Items of income, gain, deduction or loss that are denominated in a nonfunctional currency (other than the functional currency of the owner).* An item of income, gain, deduction or loss attributable to a section 987 QBU under § 1.987-2(b) that is denominated in (or determined by reference to) a nonfunctional currency (other than the owner's functional currency) shall be translated into the section 987 QBU's functional currency at the spot rate as defined in § 1.987-1(c)(1)(i) and (ii) on the day such item is properly taken into account.

(e) *Section 988 transactions—(1) In general.* Except as provided in paragraph (e)(2) of this section, section 988 shall apply to the section 988 transactions attributable to a section 987 QBU under § 1.987-2(b), and the timing of any gain or loss shall be determined under the applicable provisions of the Internal Revenue Code. Such transactions are section 987 historic items as defined in § 1.987-1(e).

(2) *Certain transactions denominated in (or determined by reference to) the owner's functional currency are not section 988 transactions.* Transactions described in section 988(c)(1)(A)(i) and (ii) and section 988(c)(1)(C) that are denominated in (or determined by reference to) the owner's functional currency and that are attributable to a section 987 QBU under § 1.987-2(b) shall not be treated as section 988 transactions to such QBU. Thus, no currency gain or loss shall be recognized by a section 987 QBU under section 988 with respect to such items.

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

Example 1. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns French DE, a section 987 DE that has a section 987 branch with the euro as its functional currency. For purposes of paragraph (b)(1) of this section, U.S. Corp uses the yearly average exchange rate under § 1.987-1(c)(2) to translate items of income, gain, deduction or loss where such rate is appropriate. U.S. Corp also properly elects to use a spot rate convention under § 1.987-1(c)(1)(ii) where the spot rate is otherwise required. Under this convention, items 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"). Accordingly, gross sales income is translated at the yearly average exchange rate and under paragraph (b)(2)(ii)(B) of this section the basis of assets

acquired during a month is translated into dollars at the convention rate. Assume that the yearly average exchange rate for 2009 is

€1 = \$1.05. For the taxable year 2009, French DE sells 1,200 units of inventory for a sales price of €3 per unit. Assume that the

purchase price for each inventory unit is €1.50. Thus, French DE's dollar gross sales will be computed as follows:

GROSS SALES

Month	# of units	€	€/ \$ 2009 ave. exchange rate	\$
Jan	100	300	€1=\$1.05	315
Feb	200	600	€1=\$1.05	630
March	0	0	€1=\$1.05	0
April	200	600	€1=\$1.05	630
May	100	300	€1=\$1.05	315
June	0	0	€1=\$1.05	0
July	100	300	€1=\$1.05	315
Aug	100	300	€1=\$1.05	315
Sept	0	0	€1=\$1.05	0
Oct	0	0	€1=\$1.05	0
Nov	100	300	€1=\$1.05	315
Dec	300	900	€1=\$1.05	945
	1,200	3,600	.....	3,780

OPENING INVENTORY AND PURCHASES

Month	# of units	€	€/ \$ convention exchange rate	\$
Opening inventory from 2008	100	150	€1=\$1.00	150
Purchases:				
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
Oct	0	0	€1=\$1.07	0
Nov	300	450	€1=\$1.08	486
Dec	0	0	€1=\$1.08	0
Total Purchases	1,200	1,800	.....	1,872

(ii) French DE uses a first in first out method of accounting for inventory (FIFO). Thus, for 2009, French DE is considered to have sold the 100 units of opening inventory (\$150), the 300 units purchased in January (\$450), the 300 units purchased in April (\$459), the 300 units purchased in July (\$477) and 200 of the 300 units purchased in

November (\$324). Thus, French DE's cost of goods sold is \$1,860. French DE's opening inventory for 2010 is 100 units of inventory with a dollar basis of \$162.

(iii) Accordingly, for purposes of section 987 French DE has gross income in dollars of \$1,920 (\$3,780-\$1,860).

Example 2. (i) The facts are the same as in *Example 1* except that for purposes of paragraph (b)(1) of this section, U.S. Corp properly elects to use a spot rate convention under § 1.987-1(c)(1)(ii) to translate items of income, gain, deduction or loss where such rate is appropriate. Thus, French DE's dollar gross sales will be computed as follows:

GROSS SALES

Sales	# of units	€	€/ \$ convention exchange rate	\$
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

GROSS SALES—Continued

Sales	# of units	€	€/ \$ convention exchange rate	\$
	1,200	3,600	.....	3,783

(ii) As in *Example 1*, French DE's cost of goods sold is \$1,860.

(iii) Accordingly, for purposes of section 987 French DE has gross income in dollars of \$1,923 (\$3,783 – \$1,860).

Example 3. The facts are the same as in *Example 1* except that French DE sold raw land on November 1, 2009 for €10,000. The yearly average rate for 2009 was €1=\$1.05. The land was purchased on October 16, 2007 for €8,000 when the convention rate was €1=\$1.00. Under paragraph (a)(1) of this section, French DE will determine the amount realized and basis in euros. Under paragraph (a)(1)(ii) of this section, the amount realized is translated into dollars at the yearly average exchange rate for 2009 as provided in paragraph (b)(2)(ii)(A) of this section (€10,000 × \$1.05 = \$10,500) and the basis at the convention rate for 2007 as provided in paragraph (b)(2)(ii)(B) of this section and § 1.987-1(c)(3) €8,000 × \$1 = \$8,000. Accordingly, the amount of gain reported by U.S. Corp on the sale of the land is \$2,500 (\$10,500 – \$8,000).

Example 4. The facts are the same as in *Example 3* except that U.S. Corp properly elects under paragraph (b)(1) of this section to use the spot rate to translate items of income, gain, deduction or loss. Accordingly, the amount realized will be translated at the convention rate on the day of sale. Assume that the convention rate for November 2009 is €1 = \$1.08. Under these facts, the amount realized is \$10,800 (€10,000 × \$1.08) and the basis on the day of purchase \$8,000 (€8,000 × \$1.00). The amount of gain reported by U.S. Corp on the sale of the land is \$2,800 (\$10,800 – \$8,000).

Example 5. The facts are the same as in *Example 1* except that on September 15, 2009, French DE provides services to an unrelated customer and receives a cash payment of €2,000 on that day. Under paragraph (b)(1) of this section, U.S. Corp translates the €2,000 item of income into dollars at the yearly average exchange rate of €1 = \$1.05. Accordingly, U.S. Corp will report income of \$2,100 from providing services.

Example 6. The facts are the same as in *Example 5* except that U.S. Corp properly elects under paragraph (b)(1) of this section to use the spot rate to translate items of income, gain, deduction or loss. Assume that the convention rate for September 2009 is €1 = \$1.06. Under these facts, U.S. Corp translates the €2,000 item of income into dollars at the convention rate of €1 = \$1.06. Accordingly, U.S. Corp will report income of \$2,120 from providing services.

Example 7. The facts are the same as in *Example 1* except that on March 31, 2009, French DE incurs €500 of rental expense, €300 of salary expense and €100 of utilities expense. Under paragraph (b)(1) of this section, U.S. Corp translates these items of expense at the yearly average exchange rate

of €1 = \$1.05. Accordingly the expenses are translated as follows: rental expense of \$525, salary expense of \$315 and utilities expense of \$105.

Example 8. The facts are the same as in *Example 7* except that U.S. Corp properly elects under paragraph (b)(1) of this section to use the spot rate to translate items of income and expense. Assume that the convention rate for March 2009 is €1 = \$1.03. Under these facts, U.S. Corp translates the €500 of rental expense, €300 of salary expense and €100 of utilities expense at the convention rate of €1 = \$1.03. Accordingly, the expenses are translated as follows: rental expense of \$515, salary expense of \$309 and utilities expense of \$103.

Example 9. The facts are the same as in *Example 1* except that during 2009, French DE incurred €100 of depreciation expense with respect to a truck. The truck was purchased on January 15, 2008, when the convention rate was €1 = \$1.02. Under paragraph (b)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic exchange rate. Since U.S. Corp has properly elected to use a spot rate convention, depreciation will be translated in accordance with the convention. Accordingly, U.S. Corp translates the €100 of depreciation to equal \$102.

Example 10. (i) The facts are the same as in *Example 1* except that on January 12, 2009, French DE performed services for a U.K. person and received £10,000 in compensation. The exchange rate on January 12, 2009, was £1 = €1.25. Under paragraph (d) of this section, French DE will translate such income into euros at the spot rate on January 12, 2009. Accordingly, French DE will take into account €12,500 of income from services in 2009. Under paragraph (b)(1) of this section, U.S. Corp translates the €12,500 item of income into dollars at the yearly average euro to dollar exchange rate. Assume that such exchange rate is €1 = \$1.10. Accordingly, U.S. Corp translates the €12,500 income from services to equal \$13,750.

(ii) On October 16, 2009, French DE disposes of the £10,000 for €10,000. Under section 988(c)(1)(C), the disposition is a section 988 transaction. Under § 1.988-2(a)(2), French DE will realize a loss of €2,500 (€10,000 amount realized less €12,500 basis). Under paragraph (b)(1) of this section, U.S. Corp translates the €2,500 loss into dollars at the yearly average euro to dollar exchange rate. Assume that such exchange rate is €1 = \$1.05. Accordingly, U.S. Corp translates the €2,500 section 988 loss to equal \$2,625.

§ 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 of a section 987 QBU.* 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.* 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 paragraph (d) of this section for all prior years to which these regulations apply, reduced by the amounts taken into account under § 1.987-5 upon a remittance for all such prior taxable years. This amount shall include amounts appropriately considered as net unrecognized exchange gain or loss under the transition rules of § 1.987-10.

(d) *Calculation of unrecognized section 987 gain or loss of a section 987 QBU 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 (7) of this section as follows:

(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 current 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 QBU's first taxable year.

(ii) *Year section 987 QBU is terminated.* If a section 987 QBU is terminated under the rules 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 day the section 987 QBU is terminated.

(2) *Step 2: Increase the aggregate amount determined in step 1 by the assets transferred from the section 987 QBU to its owner—(i) In general.* The aggregate 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)(iii) 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 aggregate of—

(A) The amount of the section 987 QBU's functional currency and the adjusted basis of any section 987 marked asset (as defined in § 1.987-1(d)) transferred from the section 987 QBU 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 as provided in paragraph (d)(2)(iii)(A) of this section; and

(B) The adjusted basis of any section 987 historic asset (as defined in § 1.987-1(e)) 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 as provided in paragraph (d)(2)(iii)(B) of this section. Such amount shall be adjusted to take into account the proper translation of depreciation, depletion and amortization as provided in § 1.987-3(b)(2)(i).

(iii) *Translation of amounts transferred from the section 987 QBU to the owner.* In the case of a transfer from the section 987 QBU to an owner of any asset the following exchange rates shall be used:

(A) In the case of an amount described in paragraph (d)(2)(ii)(A) of this section,

the spot exchange rate, as defined in § 1.987-1(c)(1), on the day of transfer.

(B) In the case of a transfer of a section 987 historic asset, the historic exchange rate for such asset as defined in § 1.987-1(c)(3).

(3) *Step 3: Decrease the aggregate amount determined in steps 1 and 2 by the owner's transfers 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 aggregate 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 (d)(3) of this section shall be decreased by the aggregate amount of liabilities transferred from the section 987 QBU to the owner. The amount of such liabilities shall be translated into the functional currency of the owner at the spot exchange rate, as defined in § 1.987-1(c)(1), on the day of transfer.

(5) *Step 5: Increase the aggregate amount determined in steps 1 through 4 by amount of liabilities transferred from the owner to the section 987 QBU.* The aggregate amount determined in paragraphs (d)(1) through (d)(4) of this section shall be increased by the aggregate amount of liabilities transferred by the owner to the section 987 QBU. The amount of such liabilities shall be translated into the functional currency of the owner, if required, at the spot exchange rate, as defined in § 1.987-1(c)(1)(i) and (ii), on the day of transfer.

(6) *Step 6: Increase the aggregate amount determined in steps 1 through 5 by the section 987 taxable loss of the section 987 QBU for the taxable year.* In the case of a section 987 taxable loss of the section 987 QBU computed under

§ 1.987-3 for the taxable year, the aggregate amount determined in paragraphs (d)(1) through (d)(5) of this section shall be increased by such section 987 taxable loss.

(7) *Step 7: 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.* In the case of section 987 taxable income of the section 987 QBU computed under § 1.987-3 for the taxable year, the aggregate amount determined in paragraphs (d)(1) through (d)(5) of this section shall be decreased by such section 987 taxable income.

(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 the QBU's functional currency and the basis of each asset on that day, less the aggregate amount of each liability on the section 987 QBU's balance sheet on that day translated, if necessary, into the owner's functional currency as provided in paragraph (e)(2) of this section. Such amount shall be determined as follows:

(i) The owner, or section 987 QBU on behalf of the owner, shall prepare 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 showing all assets and liabilities reflected on such books and records as provided in § 1.987-2(b). Assets and liabilities denominated in the functional currency of the owner shall be reflected on the balance sheet in the owner's functional currency.

(ii) The owner, or section 987 QBU on behalf of the owner, shall make adjustments necessary to conform the items reflected on the balance sheet described in paragraph (e)(1)(i) of this section to United States generally accepted accounting principles and tax accounting principles.

(iii) The owner, or section 987 QBU on behalf of the owner, shall translate 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. Assets and liabilities denominated in the functional currency of the owner are not translated.

(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 (other

than an asset or liability reflected on the balance sheet in the functional currency of the owner) shall be translated as follows:

(i) *Section 987 marked item.* A section 987 marked item as defined in § 1.987-1(d) shall be translated into the owner's functional currency at the spot exchange rate as defined in § 1.987-1(c)(1)(i) and (ii) on the last day of the taxable year.

(ii) *Section 987 historic item.* A section 987 historic item as defined in § 1.987-1(e) shall be translated into the owner's functional currency at the historic exchange rate as defined in § 1.987-1(c)(3).

(f) *Examples.* The provisions of this section are illustrated by the following examples. Unless otherwise indicated, all items are assumed to be reflected on the books and records, within the meaning of § 1.987-2(b), of the relevant section 987 QBU.

Example 1. (i) U.S. Corp is a calendar year domestic corporation with the dollar as its functional currency. On July 1, 2009, U.S. Corp establishes Japan Branch that has the yen as its functional currency. Japan Branch is a section 987 QBU of U.S. Corp. U.S. Corp properly elects to use a spot rate convention under § 1.987-1(c)(1)(ii) with respect to Japan Branch. Under this convention, the spot rate for any transaction occurring during a month is the spot rate on the first day of the month. U.S. Corp also elects under § 1.987-3(b)(1) to use this convention to translate items of income, gain, deduction, or loss into dollars. On July 1, 2009, when \$1 = ¥100 (or ¥1 = \$0.01), U.S. Corp transfers \$1,000 to Japan

Branch and raw land with a basis of \$500. Japan Branch immediately purchases ¥100,000 with the \$1,000. On the same day, Japan Branch borrows ¥10,000. Assume that for the taxable year 2009, Japan Branch earns ¥2,000 per month (total of ¥12,000 for the six month period from July 1, 2009, through December 31, 2009) for providing services and incurs ¥333.33 per month (total of ¥2,000 when rounded for the six month period from July 1, 2009, through December 31, 2009) of related expenses. Assume that all items of income earned and expenses incurred by Japan Branch during 2009 are received and paid, respectively, in yen. Further, assume that the ¥12,000 of income when properly translated under the monthly convention equals \$109.08 and that the ¥2,000 of related expenses equal \$18.18. Thus, Japan Branch's income translated into dollars equals \$90.90. Assume that the spot exchange rate on the December 1, 2009, is \$1 = ¥120 (¥1 = \$0.00833).

(ii) Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for 2009. Since 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 2009 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) of this section, U.S. Corp must determine the change in the owner functional currency net value of Japan Branch for the year 2009 in dollars. The change in the owner functional currency net value of Japan Branch for 2009 is equal to the owner functional currency net value of

Japan Branch determined in dollars on the last day of 2009, less the owner functional currency net value of Japan Branch determined in dollars on the last day of the preceding taxable year.

(A) The owner functional currency net value of Japan Branch determined in dollars on the last day of the current taxable year is determined under paragraph (e) of this section. Such amount is the aggregate of the basis of each asset on Japan Branch's balance sheet on December 31, 2009, less the aggregate of the amount of each liability on the Japan Branch's balance sheet on that day, 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, 2009:

(1) Cash of ¥120,000 [((\$1,000 transferred and immediately converted to ¥100,000) + ¥10,000 borrowed + ¥12,000 income from services - ¥2,000 of expenses).

(2) Raw land with a basis of ¥50,000.

(3) Liabilities of ¥10,000.

(C) Under paragraph (e)(2) of this section, U.S. Corp will translate these items as follows. The cash of ¥120,000 is a section 987 marked asset and the ¥10,000 liability is a section 987 marked liability as defined in § 1.987-1(d). These items are translated into dollars on December 31, 2009, using the spot rate on December 1, 2009 of ¥1 = \$ 0.00833. The raw land is a section 987 historic asset as defined in § 1.987-1(e) and is translated into the dollars at the convention rate for the day of transfer (¥1 = \$0.01). Thus, the owner functional currency net value of Japan Branch on December 31, 2009, in dollars is \$1,416.60 determined as follows:

Asset	Amount in ¥	Translation rate	Amount in \$
Cash	4 120,000	12/01/09 spot convention rate on 12/31/09 of ¥1=\$0.00833.	999.60
Land	50,000	Historic rate on 7/1/09 of ¥1=\$0.01	500.00
Total assets .....	.....	.....	1,499.60
Liability:			
Bank Loan	10,000	12/01/09 spot convention rate on 12/31/09 of ¥1 = \$0.00833.	83.30
Total liabilities .....	.....	.....	83.30
Owner functional currency net value of Japan Branch on December 31, 2009 in dollars.			1,416.30

(D) Under paragraph (d)(1) of this section, the change in owner functional currency net value of Japan Branch for 2009 is equal to the owner functional currency net value of the branch determined in dollars on December 31, 2009 (\$1,416.30) less the owner functional currency net value of the branch determined in dollars on the last day of the preceding taxable year. Since this is the first taxable year of Japan Branch, the owner functional currency net value 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 owner functional currency net value of Japan Branch for 2009 is \$1,416.30.

(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)(iii) of this section. Since no such amounts were transferred under these facts, there is no

change in the \$1,416.30 determined in step 1.

(v) *Step 3.* Under paragraph (d)(3) of this section, the aggregate amount determined in paragraphs (d)(1) and (2) of this section (steps 1-2) 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, 2009, U.S. Corp transferred to Japan Branch \$1,000 (which Japan Branch immediately converted into ¥100,000) and raw land with a basis of \$500 (equal to ¥50,000 on the day of transfer).

⁴ Opening cash of ¥100,000 + ¥10,000 borrowed + ¥12,000 income from services - ¥2,000 expenses.

Thus, the step 2 amount of \$1,416.30 is reduced by \$1,500.00 to equal (\$83.70).

(vi) *Steps 4, 5 and 6.* Since no liabilities were transferred by U.S. Corp to Japan Branch or vice versa, the amount determined after applying paragraphs (d)(1) through (d)(5) of this section is (\$83.70). Further, paragraph (d)(6) of this section does not apply since Japan Branch does not have a section 987 taxable loss.

(vii) *Step 7.* Under paragraph (d)(7) of this section, the aggregate amount determined after applying paragraphs (d)(1) through (d)(5) of this section (steps 1–5) is decreased by the section 987 taxable income of Japan Branch of \$90.90. Accordingly, the unrecognized section 987 loss of Japan Branch for 2009 is \$174.60 (–\$83.70 – \$90.90).

Example 2. (i) U.S. Corp, a calendar year domestic corporation with the dollar as its functional currency, operates in the United

Kingdom through UK Branch. UK Branch has the pound as its functional currency and is a section 987 QBU. U.S. Corp properly elects to use a spot rate convention under § 1.987–1(c)(1)(ii). Under this convention, the spot 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. Pursuant to § 1.987–3(b)(1), U.S. Corp uses the yearly average exchange rate as defined in § 1.987–1(c)(2) to translate items of income, gain, deduction, or loss into dollars for the taxable year, where appropriate. The yearly average exchange rate for 2009 was £1 = \$1.05. The closing balance sheet of UK Branch for the prior year (2008) reflected the following assets and liabilities. With respect to assets, UK Branch held—

(A) Cash of £100;

(B) Plant purchased in May 2007 with an adjusted basis of £1000;

(C) A machine purchased in May 2007 with an adjusted basis of £200;

(D) Inventory of 100 units manufactured in December 2008 with a basis of £100;

(E) Portfolio stock (as defined in § 1.987–2(b)(2)(ii)) in ABC Corporation purchased in September 2008 with a basis of £158; and

(F) \$50 acquired in 2008 (and held in a non-interest bearing account).

With respect to liabilities, UK Branch has £50 of long-term debt entered into in 2007 with F Bank, an unrelated bank. The plant, machine, inventory, stock and dollars are section 987 historic assets as defined in § 1.987–1(e). The cash of £100 and long-term debt are section 987 marked items as defined under § 1.987–1(d). Assume the U.S. Corp translated UK Branch's 2008 closing balance sheet as follows:

Assets	Amount in £	Translation Rate	Amount in \$
Cash	100	Spot convention rate in Dec. 2008 £1 = \$1	100.00
Plant	1,000	Historic rate-2007 May convention rate £1= \$0.90	900.00
Machine	200	Historic rate-2007 May convention rate £1= \$0.90	180.00
Stock	158	Historic rate-2008 Sept. convention rate £1= \$.95	150.00
Inventory	100	Historic rate-2008 Dec. convention rate £1 = \$1	100.00
Dollars	\$50	Dollars are not translated	50.00
Total assets			1,480.00
Liabilities:			
Bank Loan	£50	Spot convention rate in Dec. 2008 £1 = \$1	50.00
Total liabilities			50.00
2008 ending owner functional currency net value (in dollars).			1,430

(ii) UK Branch uses the first in first out method of accounting for inventory. In 2009, UK Branch sold 100 units of inventory for a total of £300 and purchased another 100 units of inventory in December 2009 for £100. Assume that the dollar basis of the inventory purchased in December 2009 when

translated at the December 2009 monthly convention rate is \$110; that depreciation with respect to the plant is £33 and for the machine £40⁵; and that UK Branch incurred £30 of business expenses during 2009. Assume all items of income earned and expenses incurred during 2009 are received

and paid, respectively, in pounds. The yearly average exchange rate for 2009 is £1 = \$1.05. Under § 1.987–3, UK Branch's section 987 taxable income or loss is determined as follows:

Item	Amount in £	Translation Rate	Amount in \$
Gross receipts	300	2009 yearly ave. rate £1 = \$1.05	315.00
Less:			
COGS	(100)	Historic rate-Dec. 2008 convention rate £1= \$1	(100.00)
Gross income	200		215.00
Dep:			
Plant	(33)	Historic rate-May 2007 convention rate £1= \$0.90	(29.70)
Machine	(40)	Historic rate-May 2007 convention rate £1= \$0.90	(36.00)
Other expenses	(30)	2009 yearly ave. rate £1 = \$1.05	(31.50)
Total expenses			97.20
Section 987 taxable income			117.80

Accordingly, UK Branch has \$117.80 of section 987 taxable income.

(iii) Assume that in December 2009, UK Branch transferred \$20 and £30 to U.S. Corp and that U.S. Corp transferred a computer with a basis of \$10 to UK Branch. The

convention exchange rate for December 2009 is £1 = \$1.10. Finally, assume that 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 UK Branch for 2009 is determined as follows:

(A) Step 1: *Determine the change in owner functional currency net value of UK Branch.* Under paragraph (d)(1) of this section, the

⁵ The depreciation assumptions are for illustrative purposes only and may not be consistent with true depreciation rates.

change in owner functional currency net value for the taxable year must be determined. This amount is equal to the owner functional currency net value of UK

Branch determined under paragraph (e) of this section on the last day of 2009, less the owner functional currency net value of UK Branch determined on the last day of 2008.

The owner functional currency net value of UK Branch on December 31, 2009, and the change in owner functional currency net value is determined as follows:

Asset	Amount in £	Translation rate	Amount in \$
Cash	⁶ 240	Spot convention rate in Dec. 2009 £1 = \$1.10	264.00
Plant	⁷ 967	Historic rate—May 2007 convention rate £1 = \$0.90	870.30
Machine	⁸ 160	Historic rate—May 2007 convention rate £1 = \$0.90	144.00
Inventory	100	Historic rate—Dec. 2009 convention rate £1 = \$1.10	110.00
Computer	9	Historic rate—Dec. 2009 convention rate £1 = \$1.10	10.00
Stock	158	Historic rate—Sept. 2008 convention rate £1 = \$.95	150.00
Dollars	⁹ \$ 30	Dollars are not translated	30.00
Total assets			1,578.30
Liability:			
Bank Loan	£50	Spot convention rate in Dec. 2009 £1 = \$1.10	55.00
Total liabilities			55.00
2009 ending owner functional currency net value (in dollars)			1,523.30
Less: 2008 ending owner functional currency net value (in dollars)			(\$1,430.00)
Change in owner functional currency net value.			93.30

(B) Step 2: Increase the aggregate amount described in step 1 by each owner's share of assets transferred by the section 987 QBU to its owners. 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 UK Branch to U.S. Corp during the taxable year, translated into U.S. Corp's functional currency as

provided in paragraph (d)(2)(iii) of this section. The amount of assets transferred from UK Branch to U.S. Corp during 2009 is determined as follows:

Asset	Amount in £	Translation rate	Amount in \$
£30 currency	30	Spot convention rate in Dec. 2009 £1 = \$1.10	33.00
\$20 currency	\$20	Dollars are not translated	20.00
Total			53.00

(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 UK 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 UK Branch is determined as follows:

Asset	Amount in £	Translation rate	Amount in \$
Computer	£9	Spot convention rate in Dec. 2009 £1 = \$1.10	\$10.00
Total			10.00

(D) Step 4: Decrease the aggregate amount determined in steps 1 through 3 by the amount of liabilities transferred by the section 987 QBU to the owner. 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 UK Branch to U.S. Corp. Under these facts, such amount is \$0.

determined in steps 1 through 4 must be increased by the aggregate amount of liabilities transferred by U.S. Corp to UK Branch. Under these facts, such amount is \$0.

(G) Step 7: 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)(7) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of UK Branch. The amount of UK Branch's taxable income, as determined above, is \$117.80.

(E) Step 5: Increase the aggregate amount determined in steps 1 through 4 by the amount of liabilities transferred by the owner to the section 987 QBU. Under paragraph (d)(5) of this section, the aggregate amount

(F) Step 6: Increase the aggregate amount determined in steps 1 through 5 by the section 987 taxable loss 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 increased by the section 987 taxable loss of UK Branch. Since UK Branch had no such taxable loss in 2009, paragraph (d)(6) of this section does not apply.

(v) Summary. Taking steps 1 through 7 into account, the amount of U.S. Corp's unrecognized section 987 gain or loss with

⁶ £100 on the closing 2008 balance sheet plus £300 gross receipts less £100 inventory cost, less £30 of additional expenses, less £30 transferred to U.S. Corp.

⁷ £1,000 on the closing 2008 balance sheet less £33 depreciation.

⁸ £200 on the closing 2008 balance sheet less £40 depreciation.

⁹ Dollars are reduced by \$20 transferred to U.S. Corp.

respect to UK Branch in 2009 is computed as follows:

Step	Amount in \$	Balance
1	+ 93.30	\$93.30
2	+ 53.00	146.30
3	- 10.00	136.30
4	- 0	136.30
5	+ 0	136.30
6	+ 0	136.30
7	- 117.80	18.50

Thus, U.S. Corp's unrecognized section 987 gain in 2009 with respect to U.K. Branch is \$18.50. As of the end of 2009, 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 \$48.50 (i.e., \$30 accumulated from prior years, plus \$18.50 in 2009).

§ 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. For any taxable year, the owner's section 987 gain or loss recognized with respect to a section 987 QBU shall be equal to—

(1) The owner's net unrecognized section 987 gain or loss of 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 is the quotient, equal to—

(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 total adjusted basis of the gross assets of the section 987 QBU as of the end of the taxable year (or, if terminated prior to the end of such taxable year under § 1.987-8, the day of termination) that are reflected on its year-end balance sheet (or, if terminated prior to the end of such taxable year under § 1.987-8, the balance sheet on the day terminated), translated into the owner's functional currency as provided in § 1.987-4(e)(2) and increased by the amount of the remittance.

(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 total 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 total 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(d). Accordingly, the remittance proportion in the case of a termination is 1.

(d) *Total 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 total of all amounts transferred from the section 987 QBU to the owner for the taxable year shall be determined in the owner's functional currency under § 1.987-4(d)(2) with reference to the adjusted basis of the assets transferred. Solely for this purpose, the amount of liabilities transferred from the owner to the section 987 QBU determined 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) *Total 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 total of all amounts transferred from the owner to the section 987 QBU for the taxable year shall be determined in the owner's functional currency under § 1.987-4(d)(3) with reference to the adjusted basis of the assets transferred. 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 the section 987 QBU (whether or not such transfer is made in connection with a remittance as defined in paragraphs (c) of this section) shall be determined under the rules prescribed in paragraphs (f)(2) through (f)(4) of this section.

(2) *Section 987 marked asset.* The basis of a section 987 marked asset shall be determined in the owner's functional currency and shall be the same as the amount determined under § 1.987-4(d)(2)(ii)(A).

(3) *Section 987 historic asset.* The basis of a section 987 historic asset shall be determined in the owner's functional currency and shall be the same as the amount determined under § 1.987-4(d)(2)(ii)(B).

(4) *Partner's adjusted basis in distributed assets.* See also section 732 and § 1.987-7 for purposes of determining an owner's adjusted basis of an asset distributed from a section 987 QBU owned indirectly through a section 987 partnership.

(g) *Examples.* The following examples illustrate the calculation of section 987 gain or loss under this section:

Example 1. (i) U.S. Corp, a calendar year domestic corporation with the dollar as its functional currency, operates in the U.K. through U.K. DE, an entity disregarded as an entity separate from its owner under §§ 301.7701-1 through 301.7701-3 of this chapter. U.K. DE has a section 987 branch (U.K. section 987 branch) with the pound as its functional currency. During year 2, the following transfers took place between U.S. Corp and U.K. section 987 branch. On January 5, year 2, U.S. Corp transferred to U.K. section 987 branch \$300 (which the branch used during the year to purchase services). On March 5, year 2, U.K. section 987 branch transferred a machine to U.S. Corp. Assume that the pound adjusted basis of the machine when properly translated into dollars under §§ 1.987-4(d)(2)(ii)(B) and paragraph (d) of this section is \$500. On November 1, year 2, U.K. section 987 branch transferred pound cash to U.S. Corp. Assume

that the dollar amount of the pounds when properly translated under § 1.987-4(d)(2)(ii)(A) and paragraph (d) of this section is \$2,300. On December 7, year 2, U.S. Corp transferred a truck to U.K. section 987 branch with an adjusted basis of \$2,000.

(ii) Assume that at the end of year 2, U.K. section 987 branch 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 pound cash equivalent to \$2,850. In addition, assume that U.K. section 987 branch has a pound liability entered into in year 1 with Bank A. The liability, when translated into the owner functional currency pursuant to § 1.987-4(e)(2), is equivalent to \$200. All such assets and liabilities are reflected on the books and records of U.K. section 987 branch. Assume that the net unrecognized section 987 gain for U.K. section 987 branch as determined under § 1.987-4 as of the last day of year 2 is \$80.

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

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

<i>Transfers from U.K. section 987 branch to U.S. Corp in dollars:</i>	
Machine	\$500
Cash (U.K. pounds)	2,300
	\$2,800

<i>Transfers from U.S. Corp to U.K. section 987 branch in dollars:</i>	
Cash (U.S. dollars)	\$300
Truck	2,000
	2,300

<i>Computation of amount of remittance:</i>	
Aggregate transfers from U.K. section 987 branch to U.S. Corp	\$2,800
Less: aggregate transfers from U.S. Corp to U.K. section 987 branch	(2,300)
Total remittance	500

(B) *Computation of branch gross assets plus remittance.* Under paragraph (b)(2) of this section, U.K. section 987 branch must determine the total 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.

Total basis of U.K. section 987 branch's gross assets at end of year 2 plus remittance in dollars:

Computer	\$500
Cash (U.K. pounds)	2,850
Truck	2,000
	5,350
Total gross assets	5,350
Remittance	500

Total gross assets + remittance	5,850
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(C) *Computation of remittance proportion.* Under paragraph (b) of this section, U.K. section 987 branch must compute the remittance proportion as follows:

<i>Amount of remittance</i>	<i>\$500</i>
<i>Total basis of U.K. section 987 branch's gross assets at end of Year 2, increased by amount of remittance</i>	<i>5,850</i>
<i>Remittance/gross assets</i>	<i>0.085</i>
<i>Remittance proportion</i>	<i>0.085</i>

(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 U.K. section 987 branch is determined under paragraph (a) of this section.

Net unrecognized section 987 gain	\$80
Remittance proportion	× 0.085

U.S. Corp's section 987 gain for Year 2:	\$6.80
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Example 2. U.S. Corp, a calendar year domestic corporation with the dollar as its functional currency, operates in the U.K. through U.K. DE, an entity disregarded as an entity separate from its owner. U.K. DE has a section 987 branch (U.K. section 987 branch) with the pound as its functional currency. During year 2, the following transfers took place between U.S. Corp and U.K. section 987 branch. On March 1, year 2, U.S. Corp transferred to U.K. section 987 branch a computer with a basis of \$100. On November 1, year 2, U.K. section 987 branch transferred pounds to U.S. Corp. Assume that the dollar amount of the pounds when properly translated under § 1.987-4(d)(2)(ii)(A) and paragraph (d) of this section is \$300. On the same day, U.K. section 987 branch transferred of \$20 to U.S. Corp.

(ii) Assume that at the end of year 2, U.K. section 987 branch holds assets translated (as necessary) into the owner functional currency pursuant to § 1.987-4(e)(2) consisting of a plant with a pound adjusted basis equivalent \$1,000, pound cash equivalent to \$100, a machine with a pound adjusted basis equivalent to \$200, portfolio stock (within the meaning of § 1.987-2(b)(2)(ii)) in ABC Corporation with a pound adjusted basis equivalent to \$150, inventory of 100 units with an aggregate pound adjusted basis equivalent to \$100 and a computer with a pound adjusted basis equivalent to \$100. In addition, assume that U.K. section 987 branch has a pound liability that it entered into with Bank A in year 1. When properly translated into dollars pursuant to § 1.987-4(e)(2) the principal amount of the liability is equal to \$500. All such assets and liabilities are reflected on the books and records of U.K. section 987 branch. Assume that the net unrecognized 987 gain for U.K. section 987 branch as determined under § 1.987-4 as of the last day of year 2 is \$100.

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

(A) *Computation of amount of remittance.* Under paragraphs (c)(1) and (2) of this section, U.S. Corp must determine the

amount of the remittance for year 2 in the owner's functional currency on the last day of year 2. The amount of the remittance for year 2 is \$220 determined as follows:

<i>Transfers from U.K. section 987 branch to U.S. Corp in dollars:</i>	
Cash (U.K. pounds)	\$300
Cash (U.S. dollars)	20
	320

Transfers from U.S. Corp to U.K. section 987 branch in dollars:

Computer	\$100
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Computation of amount of remittance:

Aggregate transfers from U.K. section 987 branch to U.S. Corp	\$320
Less: aggregate transfers from U.S. Corp to U.K. branch	(100)
Total remittance:	\$220

Computation of amount of remittance:

Aggregate transfers from U.K. section 987 branch to U.S. Corp	\$320
Less: aggregate transfers from U.S. Corp to U.K. branch	100
Total remittance:	220

(B) *Computation of branch gross assets plus remittance.* Under paragraph (b)(2) of this section, U.K. section 987 branch must determine the total basis of its gross assets as are reflected on its year-end balance sheet translated into dollars and must increase this amount by the amount of the remittance.

Total pound basis of U.K. section 987 branch's gross assets translated into dollars at end of Year 2:

Plant	\$1,000
Cash (U.K. pounds)	100
Inventory	100
Machine	200
Computer	100
Portfolio Stock	150
	1,650
Total gross assets	1,650
Remittance	220
	1,870

Total gross assets + remittance	1,870
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(C) *Computation of remittance proportion.* Under paragraph (b) of this section, U.K. section 987 branch must compute the remittance proportion as follows:

Amount of remittance	\$220
Total basis of U.K. section 987 branch's gross assets at end of year 2, increased by amount of remittance	1,870
Remittance/gross assets	0.118
Remittance proportion	0.118

(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 U.K. section 987 branch is determined under paragraph (a) of this section.

Net unrecognized section 987 gain	\$100.00
Remittance proportion	× 0.118

U.S. Corp's section 987 gain
for year 2 11.80

§ 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) *Source and character of section 987 gain or loss—(1) In general.* Except as otherwise provided in this section, the owner of a section 987 QBU must determine the source and character 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. The modified gross income method described in § 1.861-9T(j) cannot be used.

(3) *Method required to characterize and source section 987 gain or loss with respect to regulated investment companies and real estate investment trusts.* [Reserved].

(c) *Example.* The following example illustrates the application of this section.

Example. CFC is a controlled foreign corporation as defined in section 957 with the Swiss franc (Sf) as its functional currency. CFC holds all the interest in a section 987 DE as defined in § 1.987-1(b)(6)(iii) that has a section 987 branch with significant operations in Germany (German Branch). German Branch has the euro as its functional currency. For the year 2009, CFC recognizes section 987 gain of Sf10,000 under §§ 1.987-4 and 1.987-5. Applying the rules of this section, German Branch has total average 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)(I), 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 × Sf10,000) of the section 987 gain will be treated as foreign source general limitation income which is not subpart F income and Sf2,500 (Sf250,000/Sf1,000,000 × Sf10,000) will be treated as foreign source passive income which is subpart F income. All of the section 987 gain is treated as ordinary income.

§ 1.987-7 Section 987 partnerships.

(a) *In general.* In the case of an owner that is a partner in a section 987 partnership, this section provides rules for determining the owner's share of assets and liabilities of a section 987 QBU owned indirectly, as described in § 1.987-1(b)(4)(ii), through a section 987 partnership. In addition, this section provides rules coordinating these regulations with subchapter K of chapter 1 of the Internal Revenue Code.

(b) *Assets and liabilities of an eligible QBU or a section 987 QBU held indirectly through a partnership.* A partner's share of the assets and liabilities reflected under § 1.987-2(b) on the books and records of an eligible QBU or a section 987 QBU owned indirectly through a partnership shall be determined in a manner that is consistent with the manner in which the partners have agreed to share the economic benefits and burdens (if any), corresponding to the assets and liabilities, taking into account the rules and principles of sections 701 through 761, and the applicable regulations, including section 704(b) and § 1.701-2.

(c) *Coordination with subchapter K—(1) Partner's adjusted basis in its partnership interest—(i) In general.* Except as provided in this paragraph, a partner's adjusted basis in its section 987 partnership interest shall be maintained in the functional currency of that partner and shall not be adjusted as a result of any fluctuations in the value of the partner's functional currency and the functional currency of any section 987 QBU owned indirectly through the section 987 partnership.

(ii) *Adjustments for section 987 taxable income or loss and section 987 gain or loss—(A) Section 987 taxable income or loss.* A partner's share of the items of income, gain, deduction or loss taken into account in calculating section 987 taxable income or loss of a section 987 QBU, determined under § 1.987-3, held indirectly through a section 987 partnership shall be treated as income or loss of the section 987 partnership through which the partner indirectly owns the interest. As a result, the partner's allocable share of the items of income, gain, deduction or loss taken into account in calculating section 987 taxable income or loss of the section 987 QBU shall be taken into account, following conversion into the partner's functional currency, in determining the appropriate adjustments to the partner's adjusted basis in its partnership interest under section 705.

(B) *Section 987 gain or loss.* Solely for purposes of determining the appropriate adjustments to a partner's adjusted basis in its interest in a section 987

partnership under section 705, an individual or corporation that owns a section 987 QBU indirectly through a section 987 partnership shall treat any section 987 gain or loss of such section 987 QBU as gain or loss of the section 987 partnership. Any adjustments to the adjusted basis of a partner's interest in such section 987 partnership required under this paragraph (c)(1)(ii)(B) of this section shall occur prior to determining the effect under the Internal Revenue Code of any sale, exchange, distribution or other event.

(iii) *Adjustments for contributions and distributions.* For purposes of making adjustments to the partner's adjusted basis in its interest in a section 987 partnership, as a result of any contributions or distributions (including deemed contributions and distributions under section 752) between the section 987 partnership and the owner of a section 987 QBU owned indirectly through the partnership, such amounts will be taken into account in the owner's functional currency.

(iv) *Determination of deemed distributions and contributions under section 752—(A) Increase in partner's liabilities.* For purposes of determining the amount of any increase in a partner's share of the liabilities of the partnership, or any increase in the partner's individual liabilities by reason of the assumption by such partner of a liability of the partnership, which are reflected on the books and records of a section 987 QBU owned indirectly through such partnership and which are denominated in a functional currency different from the partner's, the amount of such liabilities shall be translated into the functional currency of the partner using the spot rate (as defined in § 1.987-1(c)(1)(i) and (ii)) on the date of such increase.

(B) *Decrease in partner's liabilities.* For purposes of determining the amount of any decrease in a partner's share of the liabilities of the partnership which were reflected on the books and records of a section 987 QBU owned indirectly through such partnership and which are denominated in a functional currency different from the partner's functional currency, the amount of such liabilities shall be translated into the functional currency of the partner using the historic rate (as defined in § 1.987-1(c)(3)) for the date on which such liabilities increased the partner's adjusted basis in its partnership interest under section 752.

(2) *Special rule for determining gain or loss on the sale, exchange or other disposition of an interest in a section 987 partnership.* For purposes of determining the amount realized by a

partner in a section 987 partnership on the sale, exchange, or other disposition of that partner's interest in such partnership, the amount of liabilities reflected on the books and records of a section 987 QBU (in a functional currency different from such partner) from which that partner is relieved as a result of such disposition, and which are included in the amount realized pursuant to section 752(d), shall be translated into the partner's functional currency using the historic exchange rate (as determined under § 1.987-1(c)(3)) for the date on which such liabilities increased the partner's adjusted basis in its partnership interest under section 752.

(d) *Examples.* The purpose of the following examples is to illustrate the application of section 987 to partnerships and their partners. The examples are not meant to be a comprehensive interpretation of the step-by-step computations involved in computing net unrecognized section 987 gain or loss. Thus, for the sake of simplicity, the examples only calculate section 987 gain or loss by reference to certain identified assets and liabilities, rather than by all the assets and liabilities of the section 987 QBU (as is required under these regulations). See § 1.987-4 and the examples therein for step-by-step computations for determining the unrecognized section 987 gain or loss of the owner of a section 987 QBU.

Example 1. Computation of an owner's net unrecognized section 987 gain or loss. (i) *Facts.* PRS is a partnership which owns QBUx, an eligible QBU, operating in the United Kingdom. QBUx has the pound as its functional currency determined under § 1.985-1 taking into account all of QBUx's activities before application of this section. PRS has two equal partners that are domestic corporations, A and B, each with the U.S. dollar as its functional currency. The portions of QBUx allocated to A and B under paragraph (b) of this section are section 987 QBUs of A and B because under § 1.987-1(b)(2), such portions are allocated from an eligible QBU with a different functional currency than A and B, respectively. Assume that PRS has no items of section 987 taxable income or loss for 2007. On January 1, 2007, A and B each contribute \$50 to PRS. PRS immediately converts the \$100 into £100. The £100 is reflected, in accordance with § 1.987-2(b), on the books and records of QBUx. On January 1, 2007, the spot rate is \$1 = £1. On December 31, 2007, the spot rate is \$1.50 = £1. Pursuant to § 1.987-3(b)(1), A and B use the yearly average exchange rate, as defined in § 1.987-1(c)(2), to translate items of income, gain, deduction, or loss into dollars for the taxable year. Assume the yearly average exchange rate is \$1.25 = £1 (\$1 = £.80). Under the PRS partnership agreement, A and B each have an equal

interest in all items of partnership income and loss.

(ii) *Calculation of net unrecognized section 987 gain or loss.* Under paragraph (b) of this section, A and B are each allocated 50 from eligible QBUx. This amount is reflected on the balance sheet of the section 987 QBU of A and B, respectively, for purposes of determining the unrecognized section 987 gain or loss under § 1.987-4. Pursuant to § 1.987-4(d), the net unrecognized section 987 gain of A's section 987 QBU and B's section 987 QBU is \$25.

Example 2. Computation of owner's net unrecognized section 987 gain or loss. (i) *Facts.* The facts are the same as Example 1, except that in addition to the £100 contributed by A and B, PRS incurred a £50 recourse liability from an unrelated third party on January 1, 2007. The liability and the £50 are both reflected on the books and records of QBUx under § 1.987-2(b). Under section 752, and the regulations thereunder, A and B bear the economic risk of loss with respect to the £50 recourse debt equally.

(ii) *Calculation of net unrecognized section 987 gain or loss.* Under paragraph (b) of this section, A and B are each allocated £75 from QBUx. In addition, under paragraph (b) of this section, A and B are each allocated £25 of the liability of QBUx because the economic burden of such liability, taking into account sections 701 through 761 of the Code, is borne equally by A and B. Under § 1.987-4(d), A and B each have net unrecognized section 987 gain of \$25.

(iii) *Determination of partner's adjusted basis in PRS.* Pursuant to paragraph (c)(1)(i) of this section and section 985(a), A and B must determine the adjusted basis in their PRS partnership interests in U.S. dollars. Under sections 722, 752(a) and paragraph (c)(1)(iv)(A) of this section, the adjusted bases in such interests are increased by the U.S. dollar amount of a deemed contribution determined using the spot rate for the date on which such liability was incurred. Therefore, A and B will increase the adjusted basis in their PRS partnership interests by \$25.

Example 3. Computation of owner's net unrecognized section 987 gain or loss. (i) *Facts.* The facts are the same as *Example 2*, except as follows: On January 1, 2007, instead of incurring a £50 recourse liability, PRS incurred a £50 nonrecourse liability from an unrelated third party, which was secured by and used to purchase non-depreciable real property located in the United Kingdom. Under the partnership agreement, A and B agree to share all items of partnership income and loss equally, except that A guaranteed the nonrecourse liability and, in addition, the partnership agreement provides that A will be allocated any gain from the sale or exchange of the non-depreciable property. Further, the partnership agreement provides that in the event the partnership liquidates prior to satisfying the liability, the non-depreciable property shall be distributed to A.

(ii) *Calculation of net unrecognized section 987 gain or loss.* Under paragraph (b) of this section, A and B are each allocated £50 from eligible QBUx. In addition, because A bears the economic burden of the nonrecourse

liability incurred by PRS and the economic benefits of the non-depreciable property securing such liability, both of which are reflected on the books and records of QBUx under § 1.987-2(b), A is allocated, for purposes of applying § 1.987-4(d), both the £50 liability and the non-depreciable property with an adjusted tax basis of £50. Under § 1.987-4(d), A's net unrecognized section 987 gain is \$0, and B's net unrecognized section 987 gain is \$25.

(iii) *Determination of partner's adjusted basis in PRS.* Pursuant to paragraph (c)(1)(i) of this section and section 985(a), A and B must determine the adjusted bases in their PRS partnership interests in U.S. dollars. Under sections 722, 752(a) and paragraph (c)(1)(iv) of this section, A's adjusted basis is increased by the U.S. dollar amount of the deemed contribution determined using the spot rate for the date on which such liability was incurred. Therefore, A will increase the adjusted basis in its PRS partnership interest by \$50.

Example 4. Computation of owner's share of items of section 987 taxable income. (i) *Facts.* The facts are the same as in Example 1, except that during 2007 PRS earns £50 which are reflected on the books and records of QBUx. In accordance with the partnership agreement, the £50 are allocated equally between A and B.

(ii) *Calculation of section 987 taxable income or loss.* Under § 1.987-3, A and B's allocable share of the taxable income of QBUx, as determined by PRS, and adjusted to conform to U.S. tax principles, is £25 each. Under § 1.987-3, A and B must convert their allocable share of the £25 into U.S. dollars using the yearly average exchange rate for the year, in accordance with § 1.987-1(c)(2). As a result, A and B each take into account as their respective distributive share of PRS income \$31.25. Under paragraph (c)(1)(ii)(A) of this section, section 985(a) and section 705, such amounts, as reflected in U.S. dollars, will be taken into account in determining any adjustments to the adjusted bases of A's and B's partnership interests. In addition, such amounts will be taken into account in calculating, under § 1.987-4, the unrecognized section 987 gain or loss of the section 987 QBUs of A and B.

Example 5. Computation of owner's share of items of section 987 taxable income. (i) *Facts.* The facts are the same as in Example 4, except A and B agree to allocate the £50 of income to A. Assume for purposes of this example that such allocation has substantial economic effect as provided under section 704(b).

(ii) *Calculation of section 987 taxable income or loss.* Under § 1.987-3, A and B's allocable share of the taxable income of QBUx, as determined by PRS, and adjusted to conform to U.S. tax principles, is £50 and £0, respectively. Under § 1.987-3, A and B must convert their allocable share into U.S. dollars using the yearly average exchange rate for the year, in accordance with § 1.987-1(c)(2). As a result, A and B must each take into account as their respective distributive share of PRS income \$62.50 and \$0, respectively. Under paragraph (c)(1)(ii)(A) of this section, section 985(a) and section 705, such amounts, as reflected in U.S. dollars,

will be taken into account in determining any adjustments to the adjusted bases of A's and B's respective partnership interests. In addition, such amounts will be taken into account in calculating, under § 1.987-4, the unrecognized section 987 gain or loss of the section 987 QBUs of A and B.

Example 6. Election by de minimis partner to not take into account section 987 gain or loss. (i) *Facts.* The facts are the same as in *Example 1*, except assume that A owns, directly or indirectly, less than 5% of the total capital and profits interest in PRS and, as a result, is eligible to elect, under § 1.987-1(b)(1)(ii) not to apply the provisions of the regulations under section 987 for purposes of taking into account the section 987 gain or loss of A's section 987 QBU. Assume further that A makes such election. On January 1, 2008, A sells its interest to an unrelated third party, C, for \$75.

(ii) *Determination of partner's adjusted basis in PRS.* Pursuant to paragraph (c)(1)(i) of this section and section 985(a), A must determine the adjusted basis of its PRS partnership interest in U.S. dollars. A's basis in PRS is \$50, the amount of its contribution to PRS.

(iii) *Sale of partnership interest by A.* Under section 1001, A's amount realized on the sale of the partnership interest to C is \$75. A's adjusted basis of its PRS partnership interest is \$50, the amount of A's contribution to PRS, unadjusted by the fluctuations between the pound and the U.S. dollar. A's gain on the sale of the partnership interest is \$25.

§ 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 (d) of this section provides certain effects of terminations. Paragraph (e) 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 when—

(1) Its activities cease, such that it no longer meets the definition of an eligible QBU as defined in § 1.987-1(b)(3);

(2) Substantially all (within the meaning of section 368(a)(1)(C)) of the section 987 QBU's assets are transferred from such section 987 QBU to its owner, as provided under § 1.987-2(c). 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 (for example, a contribution of property to a DE or a partnership) as provided under § 1.987-2(c) shall be reduced by assets that are transferred from the owner to such section 987 QBU, as provided under

§ 1.987-2(c), pursuant to the same transaction;

(3) 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; or

(4) The owner of such 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.* 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.* 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 and the acquiring corporation is a foreign corporation that is not a controlled foreign corporation immediately after 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) *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. As a result, any net unrecognized section 987 gain or loss of the section 987 QBU is recognized. See § 1.987-5. For purposes of the preceding sentence, the amount of net unrecognized section 987 gain or loss is determined as of the date of termination by closing the books and records of the section 987 QBU on that date.

(e) *Examples.* The following examples illustrate the principles of this section:

Example 1. Cessation of operations. (i) *Facts.* DC, a domestic corporation, has a sales office in Country X (Country X Branch) that is a section 987 QBU. DC closes its Country X Branch.

(ii) *Analysis.* The cessation of the activities of the Country X Branch causes a termination of the section 987 QBU under paragraph (b)(1) of this section.

Example 2. Incorporation of section 987 QBU. (i) *Facts.* DC, a domestic corporation, has a branch in Country X (Country X Branch) that is a section 987 QBU. DC transfers all the assets and liabilities of Country X Branch to DS, a domestic corporation, in exchange for stock of DS in a transaction qualifying under section 351.

(ii) *Analysis.* Country X Branch terminates pursuant to paragraph (b)(1) of this section because the Country X Branch ceases to be an eligible QBU of DC.

Example 3. Cessation of controlled foreign corporation status. (i) *Facts.* DC, a domestic corporation, owns all of the stock of FC, a controlled foreign corporation as defined in section 957. FC has a section 987 QBU. FA, a foreign corporation owned solely by foreign persons, purchases all of the FC stock. FC will not constitute a controlled foreign corporation after the transaction.

(ii) *Analysis.* Because FC ceases to qualify as a controlled foreign corporation after the sale of the FC stock, FC's section 987 QBU terminates pursuant to paragraph (b)(3) of this section.

Example 4. Section 332 liquidation. (i) *Facts.* DC, a domestic corporation, operates in Country X through FC, a wholly-owned foreign corporation organized under the laws of Country X. FC also has a branch in Country Y (Country Y Branch) that is a section 987 QBU. Pursuant to a liquidation described in section 332, FC transfers all of its assets and liabilities to DC.

(ii) *Analysis.* FC's liquidation is a termination as provided in paragraph (b)(4) of this section because FC ceases to exist. The exception for certain section 332 liquidations provided under paragraph (c)(1) of this section does not apply because DC is a domestic corporation and FC is a foreign corporation. See paragraph (c)(1)(ii) of this section.

Example 5. Transfers to and from section 987 QBU pursuant to the same transaction.

(i) *Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in Country X and that business is an eligible QBU and a section 987 QBU (Country X QBU) of DC1. DC2, a domestic corporation, contributes property to Entity A in exchange for a 95% interest in Entity A. The property DC2 contributes to Entity A is used in the business conducted by the Country X QBU and is reflected on its books and records as provided under § 1.987-2(b). Moreover, Entity A is converted to a partnership as a result of the contribution. See Rev. Rul. 99-5 (situation 2), (1999-1 CB 434). See § 601.601(d)(2) of this chapter. Also, as a result of the contribution, and pursuant to § 1.987-2(c)(5), 95% of the assets and liabilities on the books and records of DC1's section 987 QBU are deemed to be transferred from such QBU to DC1, and DC1 is deemed to transfer to such QBU 5% of the

property, as determined under § 1.987-7, contributed by DC2 to Entity A.

(i) *Analysis.* As a result of the contribution of property from DC2 to Entity A, assets were transferred from DC1's section 987 QBU to DC1. Similarly, assets were transferred from DC1 to its section 987 QBU as a result of the contribution. Accordingly, for purposes of determining whether substantially all the assets of Country X QBU were transferred from DC1's section 987 QBU as provided under paragraph (b)(2) of this section, the assets transferred from DC1's section 987 QBU to DC1 under § 1.987-2(c) are reduced by the amount of assets transferred from DC1 to such section 987 QBU pursuant to the contribution.

§ 1.987-9 Recordkeeping requirements.

(a) *In general.* A taxpayer that is an owner of a section 987 QBU shall keep such reasonable records as are sufficient to establish the QBU's section 987 taxable income or loss and section 987 gain or loss. See section 987 and section 6001 and the applicable regulations.

(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:

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

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

(3) The exchange rates used to translate items of income, gain, deduction or loss of each section 987 QBU into the owner's functional currency. 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 each section 987 QBU into the owner's functional currency. 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 each section 987 QBU of the owner translated into the functional currency of the owner.

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

(7) The amount of assets and liabilities transferred by the owner to a 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 unrecognized section 987 gain or loss at the close of the taxable year.

(11) If a remittance is made, the average tax book value of assets as determined under § 1.861-9T(g).

(12) The transition information required to be determined under § 1.987-10(c)(2)(v).

(c) *Retention of records.* The records required by this section must be kept at all times available for inspection by the Internal Revenue Service, and shall be retained so long as the contents thereof may become material in the administration of the Internal Revenue Code.

§ 1.987-10 Transition rules.

(a) *Scope*—(1) *In general.* 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 paragraph (b) of this section). A taxpayer to whom this section applies must transition from the method previously used by such taxpayer to comply with section 987 (the "prior section 987 method") to the method prescribed by these regulations pursuant to the rules set forth in paragraph (c) of this section.

(2) *Limitation where the prior method was unreasonable.* Notwithstanding paragraph (a)(1) of this section, if the prior section 987 method was unreasonable (including the case where the taxpayer failed to make the determinations required under section 987 for any open taxable year), then the taxpayer must apply the rules of paragraph (c)(4) of this section (and cannot apply the rules of paragraph (c)(3) of this section) to transition to the method prescribed by these regulations.

(b) *Transition date.* The transition date is the first day of the first taxable year to which these regulations apply to a taxpayer.

(c) *Transition methods and corresponding rules*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, a taxpayer must transition from its prior method to the method prescribed by these regulations under the "deferral transition method" of paragraph (c)(3) of this section or the "fresh start transition method" of paragraph (c)(4) of this section. If a taxpayer fails to comply with the rules of this section, the Area Director, Field Examination, Small Business/Self Employed or the Director, Field Operations, Large and Mid-Size Business having jurisdiction of the

taxpayer's return for the taxable year shall determine the appropriate transition method.

(2) *Conformity rules.* The taxpayer (including all members that file a consolidated return that includes that taxpayer), and any controlled foreign corporation as defined in section 957 in which the taxpayer owns more than 50 percent of the voting power or stock (as determined in section 957(a)), must consistently apply the same transition method for each qualified business unit subject to section 987 owned on the transition date.

(3) *Deferral transition method*—(i) *In general.* Pursuant to the deferral transition method prescribed by this paragraph (c)(3), section 987 gain or loss must be determined on the transition date under the taxpayer's prior section 987 method as if all qualified business units of the taxpayer subject to section 987 (taking into account the conformity rules of paragraph (c)(2) of this section) terminated on the last day of the taxable year preceding the transition date. This deemed termination applies solely for purposes of this section. Any section 987 gain or loss determined with respect to a section 987 QBU under the preceding sentence shall not be recognized on the transition date but shall be considered as net unrecognized section 987 gain or loss of the section 987 QBU in the first taxable year for which these regulations are effective (in addition to any net unrecognized section 987 gain or loss otherwise determined for such taxable year). Recognition of net unrecognized section 987 gain or loss determined under the preceding sentence is governed by § 1.987-5 for periods after the transition date. The owner of a qualified business unit that is deemed to terminate under these rules is treated as having transferred all of the assets and liabilities attributable to such qualified business unit to a new section 987 QBU on the transition date.

(ii) *Translation rates used to determine the amount of assets and liabilities transferred from the owner to the section 987 QBU for the section 987 QBU's first taxable year beginning on the transition date.* The exchange rates used to determine the amount of assets and liabilities transferred from the owner to the section 987 QBU on the transition date (for example, for purposes of making calculations under § 1.987-4) under the deferral transition method in this paragraph (c)(3) shall be determined with reference to the historic exchange rates on the day the assets were acquired or liabilities entered into by the qualified business unit deemed terminated, adjusted to

take into account any gain or loss determined under paragraph (c)(3)(i) of this section. See *Examples 1 and 2* of paragraph (d) of this section.

(4) *Fresh start transition method*—(i) *In general.* Pursuant to the fresh start transition method prescribed by this paragraph (c)(4), on the transition date all qualified business units of the taxpayer subject to section 987 (taking into account the conformity rules of paragraph (c)(2) of this section) are deemed terminated on the last day of the taxable year preceding the transition date. This deemed termination applies solely for purposes of this section. No section 987 gain or loss is determined or recognized on such deemed termination. The owner of a qualified business unit that is deemed to terminate under this method is treated as having transferred all of the assets and liabilities attributable to such qualified business unit to a section 987 QBU on the transition date.

(ii) *Translation rates used to determine the amount of assets and liabilities transferred from the owner to the section 987 QBU for the section 987 QBU's first taxable year on the transition date.* The exchange rates used to determine the amount of assets and liabilities transferred from the owner to the section 987 QBU on the transition date (for example, for purposes of making calculations under § 1.987-4) under the fresh start transition method of this paragraph (c)(4) shall be determined with reference to the historic exchange rates on the day the assets were acquired or liabilities entered into by the qualified business unit deemed terminated. See *Example 3* of paragraph (d) of this section.

(5) *Double counting prohibited.* The transition method used by the taxpayer

cannot result in taking into account section 987 gain or loss with respect to an asset or liability attributable to a period prior to the transition date more than once.

(6) *Reporting.* The taxpayer must attach a statement to its return for the first taxable year beginning on the transition date providing the following information:

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

(ii) The transition method used by the taxpayer under paragraph (c) of this section for each qualified business unit.

(iii) If the taxpayer uses the deferral transition method prescribed in paragraph (c)(3) of this section with respect to a qualified business unit, an explanation of the method used to determine section 987 gain or loss.

(iv) If the taxpayer uses the deferral transition method prescribed in paragraph (c)(3) of this section with respect to a qualified business unit, the amount treated as net unrecognized section 987 gain or loss under paragraph (c)(3)(i) of this section.

(v) The method used by the taxpayer for determining the exchange rates used to translate the basis of assets and the amount of liabilities of a section 987 QBU into the functional currency of the owner on the transition date as provided in paragraphs (c)(3)(ii) and (c)(4)(ii) of this section for purposes of applying these regulations.

(d) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Deferral transition method. (i) U.S. Corp is a domestic corporation with the dollar as its functional currency. U.S. Corp owns UK Branch, a branch with the pound as its functional currency. UK Branch was formed on January 1, 2006. U.S. Corp uses the method prescribed in the 1991 proposed section 987 regulations to determine the section 987 gain or loss of UK Branch. U.S. Corp contributed £6,000 to UK Branch on January 1, 2006. On the same day, UK Branch bought a truck for £4,000 and a computer for £1,000. Assume that the spot rate on January 1, 2006, is £1 = \$1. UK Branch had profits determined under § 1.987-1(b)(1)(i) through (iii) of the 1991 proposed section 987 regulations of £250 in each taxable year of 2006, 2007, 2008, and 2009. Assume that the average exchange rates used to translate UK Branch's profits under the 1991 proposed section 987 regulations were as follows: 2006—£1 = \$1.10; 2007—£1 = \$1.20; 2008—£1 = \$1.30; 2009—£1 = \$1.40. UK Branch makes no remittances to U.S. Corp in any year. On January 1, 2010, UK Branch transitions to the method provided in §§ 1.987-1 through 1.987-11 of these regulations pursuant to paragraph (a) of this section. U.S. Corp chooses to use the deferral transition method of paragraph (c)(3) of this section in transitioning from its prior section 987 method (the method set forth in the 1991 proposed section 987 regulations) to the method prescribed in the §§ 1.987-1 through 1.987-11 of these regulations. The spot rate on December 31, 2009, is £1 = \$2.

(ii) Pursuant to paragraph (c)(3) of this section, U.S. Corp must determine UK Branch's section 987 gain or loss on January 1, 2010 using its prior section 987 method (the method prescribed under the 1991 proposed section 987 regulations), as if UK Branch terminated on December 31, 2009. On December 31, 2009, UK Branch has an equity pool of £7,000 and a basis pool of \$7,250 determined under the 1991 proposed section 987 regulations based on the following amounts:

Asset	Amount in £	Translation rate	Amount in \$
Cash	£1,000	Spot rate on 1/1/06 of £1=\$1	\$1,000
Cash	250	Ave. rate for 2006 of £1=\$1.10	275
Cash	250	Ave. rate for 2007 of £1=\$1.20	300
Cash	250	Ave. rate for 2008 of £1=\$1.30	325
Cash	250	Ave. rate for 2009 of £1=\$1.40	350
Truck	*4,000	Spot rate on 1/1/06 of £1=\$1	4,000
Computer	*1,000	Spot rate on 1/1/06 of £1=\$1	1,000
Total assets	7,000	.....	7,250
Liabilities	0	.....	0

* Depreciation not taken into account for purposes of this example.

Accordingly, under § 1.987-3(h)(3)(i) of the 1991 proposed section 987 regulations, UK Branch determines its section 987 gain or loss on December 31, 2009, as follows:

Equity Pool on 12/31/09	£7,000	Multiplied by spot rate on date of deemed termination of £1=\$2	×\$2	Section 987 gain	6,750
		Spot Value of Equity Pool	14,000	(iii) Under paragraph (c)(3)(i) of this section, U.S. Corp does not recognize the \$6,750 of section 987 gain determined on the transition date. Instead, the \$6,750 will be treated as net unrecognized section 987 gain of UK Branch for 2010 and subsequent years	
		Less 100% of Basis Pool	(7,250)		

(in addition to any net unrecognized section 987 gain or loss otherwise determined at the close of 2010 and subsequent years). Recognition of net unrecognized section 987 gain or loss is governed by § 1.987-5.

(iv) Pursuant to paragraph (c)(3)(ii) of this section, when computing the exchange rates used to determine the amount of assets and liabilities transferred from U.S. Corp to UK

Branch on the transition date, U.S. Corp must adjust the historic exchange rates attributable to such assets to take into account UK Branch's section 987 gain determined under paragraph (c)(3) of this section. Under these facts, where all of UK Branch's assets are considered to generate deferred section 987 gain, U.S. Corp takes into account this section 987 gain by translating the assets

deemed contributed by U.S. Corp to UK Branch on the transition date using the same spot rate it used to determine UK Branch's section 987 gain on the deemed termination date of December 31, 2009. Accordingly, on January 1, 2010, U.S. Corp translates the assets deemed contributed (cash is segregated for ease of illustration) to UK Branch as follows:

Asset	Amount in £	Translation rate	Amount in \$
Cash	£1,000	Spot rate on 12/31/09 of £1=\$2	\$2,000
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Truck	4,000	Spot rate on 12/31/09 of £1=\$2	8,000
Computer	1,000	Spot rate on 12/31/09 of £1=\$2	2,000
Total assets	7,000	.....	14,000
Liabilities	0	.....	0

Example 2. Deferral transition method. (i) The facts are the same as in *Example 1* except that U.S. Corp and UK Branch use an “earnings only” approach to determine section 987 gain or loss prior to the transition date. Under this approach, U.S. Corp maintains a basis and equity pool for UK Branch's earnings and a separate basis and equity pool for UK Branch's capital. Section 987 gain or loss is only recognized on remittances of earnings (but not with respect to capital) under principles similar to those of the 1991 proposed section 987 regulations. Remittances are first considered as distributed from the earnings equity pool and then from the capital equity pool. For purposes of this example, this method is assumed to be a reasonable section 987 method and does not violate § 1.987-10(a)(2).

(ii) Using principles similar to those set forth in § 1.987-2 of the 1991 proposed section 987 regulations, the earnings equity pool of UK Branch is £1,000 (£250 earned in each taxable year of 2006, 2007, 2008 and 2009) and the corresponding earnings basis pool is \$1,250 (\$275 in 2006, \$300 in 2007, \$325 in 2008 and \$350 in 2009). The capital equity pool is £6,000 and the corresponding capital basis pool is \$6,000 (contributed cash of £6,000 translated to equal \$6,000—which U.S. Corp can trace to contributed cash

remaining of £1,000 with a translated basis equal to \$1,000; a truck of £4,000 with a translated basis equal to \$4,000; and a computer of £1,000 with a translated basis equal to \$1,000).

(iii) Pursuant to paragraph (c)(3)(i) of this section, U.S. Corp must determine UK Branch's section 987 gain or loss on January 1, 2010, using its prior section 987 method (the “earnings only” method), as if UK Branch terminated on December 31, 2009. Using principles similar to § 1.987-3(h) of the 1991 proposed section 987 regulations with respect to the earnings equity and basis pool, U.S. Corp would determine \$750 of section 987 gain as follows:

Earnings Equity Pool on 12/31/09	£1,000
Multiplied by spot rate on date of deemed termination of £1=\$2	× \$2
	\$2,000
Spot Value of Earnings Equity Pool	\$2,000
Less 100% of Earnings Basis Pool	(\$1,250)
Section 987 gain	\$750

(iv) Under paragraph (c)(3)(i) of this section, U.S. Corp does not recognize the \$750 of section 987 gain determined on the transition date. Instead, the \$750 will be treated as net unrecognized section 987 gain of UK Branch for 2010 and subsequent years (in addition to any net unrecognized section 987 gain or loss otherwise determined at the close of 2010 and subsequent years). Recognition of net unrecognized section 987 gain or loss is governed by § 1.987-5.

(v) Pursuant to paragraph (c)(3)(ii) of this section, when computing the exchange rates used to determine the amount of assets and liabilities transferred from U.S. Corp to UK Branch on the transition date, U.S. Corp must adjust the historic exchange rates attributable to such assets to take into account UK Branch's section 987 gain determined under paragraph (c)(3) of this section. Under these facts, U.S. Corp may reasonably take into account UK Branch's section 987 gain by translating those UK Branch's assets that generated such gain using the same spot rate it used to determine UK Branch's section 987 gain on the termination date of December 31, 2009 and by determining the translation rate of other assets by reference to the traced basis of such assets. Accordingly, on January 1, 2010, U.S. Corp translates the deemed contributions to UK Branch as follows:

Asset	Amount in £	Translation rate	Amount in \$
Contributed Cash	£1,000	Spot rate on 1/1/06 of £1=\$1	\$1,000
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Cash	250	Spot rate on 12/31/09 of £1=\$2	500
Truck	4,000	Spot rate on 1/1/06 of £1=\$1	4,000
Computer	1,000	Spot rate on 1/1/06 of £1=\$1	1,000
Total assets	7,000	.....	8,000
Liabilities	0	.....	0

(vi) If UK Branch was not able to trace historic dollar basis as set forth in paragraph (v) of this *Example 2*, when translating the assets deemed contributed to UK Branch on

January 1, 2010, under paragraph (c)(3)(ii) of this section, U.S. Corp would be required to use exchange rates that take into account a reasonable allocation of the aggregate historic

basis and the \$750 of deferred section 987 gain to the UK Branch assets.

Example 3. Fresh start transition method.

(i) The facts are the same as in *Example 1*,

except that U.S. Corp chooses to use the fresh start transition method of paragraph (c)(4) of this section in transitioning from the 1991 proposed regulations to the method prescribed in the current regulations. Pursuant to paragraph (c)(4)(i) of this section,

UK Branch is deemed to terminate on December 31, 2009. However, no section 987 gain or loss will be determined or recognized. On January 1, 2010, when translating the assets deemed contributed to UK Branch, U.S. Corp will use the historic exchange rates

existing on the date the assets were acquired by UK Branch pursuant to paragraph (c)(4)(ii) of this section. Accordingly, U.S. Corp translates the assets deemed contributed (cash is segregated for ease of illustration) to UK Branch as follows:

Asset	Amount in £	Translation rate	Amount in \$
Contributed Cash	£1000	Spot rate on 1/1/06 of £1=\$1	\$1,000
Cash	250	Ave. rate for 2006 of £1=\$1.10	275
Cash	250	Ave. rate for 2004 of £1=\$1.20	300
Cash	250	Ave. rate for 2005 of £1=\$1.30	325
Cash	250	Ave. rate for 2006 of £1=\$1.40	350
Truck	4000	Spot rate on 1/1/06 of £1=\$1	4,000
Computer	1000	Spot rate on 1/1/06 of £1=\$1	1,000
Total assets	7000	.....	7,250
Liabilities	0	.....	0

(ii) If UK Branch was not able to trace historic dollar basis as set forth in paragraph (i) of this Example 3, when translating the assets deemed contributed to UK Branch on January 1, 2010, under paragraph (c)(3)(ii) of this section, U.S. Corp would be required to use exchange rates that take into account a reasonable allocation of the aggregate historic basis of the UK Branch assets.

§ 1.987-11 Effective date.

(a) *In general.* Except as otherwise provided in this section, these regulations shall apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**.

(b) *Election to apply these regulations to taxable years beginning after the date of publication of a Treasury decision adopting this rule as a final regulation in the Federal Register.* A taxpayer may elect to apply these regulations to taxable years beginning after the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. Such election shall be binding on all members that file a consolidated return with the taxpayer and any controlled foreign corporation, as defined in section 957, in which the taxpayer owns more than 50 percent of the voting power or stock (as determined in section 957(a)). An election made under this paragraph shall be made in accordance with § 1.987-1(f).

Par. 6. Section 1.988-1 is amended by:

1. Adding paragraphs (a)(3) and (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) * * *

(3) *Certain transactions of a section 987 QBU denominated in the functional currency of the owner are not treated as section 988 transactions.* Transactions described in § 1.987-3(e)(2) (regarding certain transactions that are denominated in the functional currency of the owner of a section 987 QBU) are not treated as section 988 transactions to a section 987 QBU. Thus, no currency gain or loss shall be recognized by a section 987 QBU under section 988 with respect to such items.

(4) *Treatment of assets and liabilities of a partnership or DE that are not attributed to an eligible QBU—(i) Scope.* This paragraph (a)(4) applies to assets and liabilities of a partnership, or of an entity disregarded as an entity separate from its owner for U.S. Federal income tax purposes (DE), that are not attributable to an eligible QBU (within the meaning of § 1.987-1(b)(3)) as provided under § 1.987-2(b).

(ii) *Partnerships.* For purposes of applying section 988 and the applicable regulations to transactions involving the assets and liabilities described in paragraph (a)(4)(i) of this section that are held by a partnership, the owners of the 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 the 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 of such assets and liabilities.

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

Example. Liability held through a 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 that has the yen as its functional currency. On January 1, year 1, 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, year 1, P used the yen it borrowed from the lender to acquire 100% of the stock of F, a foreign corporation, from an unrelated person. P also holds an eligible section 987 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 P books and records 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 are not reflected on such books and records for purposes of section 987 pursuant to § 1.987-2(b)(2)(i)(A) and (C), respectively.

(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 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 share of such stock and liability, determined under § 1.987-7(b), for purposes of applying section 988. As a result, P's becoming the obligor under the portion of the yen-denominated note that is treated as being 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 disposition of yen on payments of interest and principal on the liability, to the extent such yen are treated as

owned by X, are section 988 transactions under paragraphs (a)(1)(i) and (a)(3) of this section. P's becoming the obligor under 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.

(5) [Reserved].

* * * * *

(10) * * *

(ii) *Certain transfers.* (A) 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 the owner where as a result of such transfers the currency or other such item—

(i) Loses its character as nonfunctional currency or an item described in paragraph (a)(2) of this section; or

(ii) Where the source of the exchange gain or loss could be altered absent the application of this paragraph (a)(10)(ii).

(B) Such exchange gain or loss 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 which 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), (a)(5), 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 the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. If a taxpayer makes an election under § 1.987-11(b), then the effective date of the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section with respect to the taxpayer shall be consistent with such election.

Par. 7. 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 of a qualified business unit.

(ii) *Effective date.* Generally, paragraph (b)(2)(i) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. If a taxpayer makes an election

under § 1.987-11(b), then the effective date of paragraph (b)(2)(i) with respect to the taxpayer shall be consistent with such election.

* * * * *

Par. 8. Section 1.989(a)-1 is amended as follows:

1. The last sentence of paragraph (b)(2)(i) is revised.

2. Paragraph (b)(4) is added.

The revision and addition reads as follows:

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

(b) * * *

(2) * * *

(i) *Persons—** * * A trust or estate is a QBU of the beneficiary.

* * * * *

(4) *Effective date.* Generally, the revisions to paragraph (b)(2)(i) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following the date of publication of a Treasury decision adopting this rule as a final regulation in the **Federal Register**. If a taxpayer makes an election under § 1.987-11(b), then the effective date of the revisions to paragraph (b)(2)(i) of this section with respect to the taxpayer shall be consistent with such election.

* * * * *

§ 1.989(c)-1 [Removed]

Par. 9. Section 1.989(c)-1 is removed.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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