

§ 1.987-1 Profit and loss method of accounting for a qualified business unit of a taxpayer having a different functional currency from the taxpayer. [Reserved]

§ 1.987-2 Accounting for gain or loss on certain transfers of property. [Reserved]

§ 1.987-3 Termination. [Reserved]

§ 1.987-4 Special rules relating to QBU branches of foreign taxpayers. [Reserved]

§ 1.987-5 Transition rules for certain qualified business units using a profit and loss method of accounting for taxable years beginning before January 1, 1987.

(a) *Applicability*—(1) *In general.* This section applies to qualified business unit (QBU) branches of United States persons, whose functional currency (as defined in section 985 of the Code and the regulations thereunder) is other than the United States dollar (dollar) and that used a profit and loss method of accounting for their last taxable year beginning before January 1, 1987. Generally, a profit and loss method of accounting is any method of accounting under which the taxpayer calculates the profits of a QBU branch in its functional currency and translates the net result into dollars. For all taxable years beginning after December 31, 1986, such QBU branches must use the profit and loss method of accounting as described in section 987, except to the extent otherwise provided in regulations under section 985 or any other provision of the Code. See § 1.989(c)-1 regarding transition rules for QBU branches of United States persons that have a nondollar functional currency and that used a net worth method of accounting for their last taxable year beginning before January 1, 1987.

(2) *Insolvent QBU branches.* A taxpayer may apply the principles of this section to a QBU branch that used a profit and loss method of accounting for its last taxable year beginning before January 1, 1987, whose \$E pool (as defined in paragraph (d)(3)(i) of this section) is negative. For taxable years beginning on or after October 25, 1991, the principles of this section shall apply to insolvent QBU branches.

(b) *General rules.* Generally, section 987 gain or loss occurs when a QBU branch makes a remittance. A remittance is considered to be made from one or more functional currency pools under rules provided in paragraph (c) of this section. In general, the amount of section 987 gain or loss from a remittance equals the difference between the dollar value of the functional currency adjusted basis of the property remitted and the portion of the dollar basis in the applicable pool. Section 987 gain or loss is calculated under a 4-step procedure described in paragraph (d) of this section. Section 987 gain or loss attributable to a remittance is realized and must be recognized in the taxable year of the remittance except to the extent otherwise provided in regulations.

(c) *Determining the pool(s) from which a remittance is made*—(1) *Remittances made during taxable years beginning after December 31, 1986, and before October 25, 1991.* A remittance made during taxable years beginning after December 31, 1986 and before October 25, 1991, first represents an amount of the QBU branch's post-86 profits pool (including functional currency profits for the current taxable year determined without regard to remittances made during the current year). To the extent the functional currency amount of the remittance exceeds the post-86 profits pool, it is considered to come out of the EQ pool. Paragraph (d)(2) of this section describes the EQ pool and the post-86 profits pool.

(2) *Remittances made in taxable years beginning on or after October 25, 1991.* For remittances made in taxable years beginning on or after October 25, 1991, the post-86 profits and EQ pools are combined into one pool called the equity pool. Therefore, remittances made during those taxable years will only come from the equity pool. The dollar basis of, and section 987 gain or loss on, such remittances shall be calculated utilizing the principles set forth in paragraphs (d)(4) and (5) of this section.

(d) *Calculation of section 987 gain or loss*—(1) *In general.* This paragraph (d) describes the 4-step procedure for calculating section 987 gain or loss.

(2) *Step 1—Calculate the amount of the functional currency pools*—(i) *EQ pool*—(A) *Beginning pool.* The beginning

amount of the EQ pool is equal to the functional currency adjusted bases of a QBU branch's assets less the functional currency amount of the QBU branch's liabilities at the end of the taxpayer's last taxable year beginning before January 1, 1987, as these amounts are determined under the rules of paragraphs (e) and (f) of the section. The district director may allow for additional adjustments to the beginning amount of the EQ pool to prevent the recognition of section 987 gain or loss due to factors unrelated to the movement of exchange rates.

(B) *Adjusting the EQ pool.* The EQ pool is increased by the functional currency amount of any transfer (as determined under section 987) to the QBU branch made during the current taxable year or any prior taxable year beginning after December 31, 1986. If the transfer is made in a nonfunctional currency, this amount is translated into the QBU branch's functional currency at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The method for determining the rate must be applied consistently each quarter. The EQ pool is decreased by the functional currency amount of any remittance (as determined under section 987) made during a prior taxable year beginning after December 31, 1986, that is considered remitted from the EQ pool under paragraph (c) of this section. The EQ pool must also be decreased by any transfer from the QBU branch that is not a remittance.

(ii) *Post-86 profits pool.* The amount of a QBU branch's post-86 profits pool is calculated at the end of each taxable year beginning after December 31, 1986. The opening balance of the post-86 profits pool at the beginning of the first taxable year beginning after December 31, 1986, is zero. The post-86 profits pool is increased by the functional currency amount of the QBU branch's profits (determined under section 987) for the taxable year. The post-86 profits pool is decreased by the functional currency amount of the QBU branch's losses (determined under section 987) for the taxable year and the amount of any remittances by the QBU branch during the taxable year from

the post-86 profits pool as provided under paragraph (c) of this section.

(iii) *Adjustments to the equity pool.* For remittances made in taxable years beginning on or after October 25, 1991 under paragraph (c)(2) of this section, the post-86 profits and EQ pools are combined into one pool called the equity pool. Additions to and subtractions from the equity pool shall be made utilizing the principles of paragraphs (d)(2)(i)(B) and (ii) of this section. For example, remittances shall reduce the equity pool.

(3) *Step 2—Calculate the dollar basis of the pools—(i) Dollar basis of the EQ pool—(A) Beginning dollar basis.* The beginning dollar basis of the EQ pool (hereinafter referred to as the \$E pool) equals:

(1) The dollar amount of all the QBU branch's profits reported on the taxpayer's income tax returns for taxable years beginning before January 1, 1987, plus the total dollar amount of all transfers to the QBU branch during that period (properly reflected on the taxpayer's books), less

(2) The dollar amount of all the QBU branch's losses reported on the taxpayer's income tax returns for such years, and the total dollar basis of all remittances and all transfers made by the QBU branch during that period (properly reflected on the taxpayer's books).

A QBU branch's profits and losses shall be properly adjusted for foreign taxes of the QBU branch.

(B) *Adjusting the \$E pool.* The \$E pool is increased by the dollar amount of any transfers to the QBU branch made during the current taxable year or any prior taxable year beginning after December 31, 1986. If a transfer is made in a currency other than the dollar, the amount of the currency is translated into dollars at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The \$E pool is decreased by the dollar basis of any remittance made during a prior taxable year beginning after December 31, 1986, that is considered remitted from the \$E pool under paragraphs (c) and (d)(4) of these section. The \$E pool is also reduced by the amount of a transfer (other than a remittance) from the

QBU branch translated into dollars at the spot rate (determined under the principles of section 988 and the regulations thereunder) on the date of the transfer. The method for determining the spot rate must be applied consistently to all transfers to and from a QBU branch.

(ii) *Dollar basis of the post-86 profits pool.* The amount of a QBU branch's dollar basis in the post-86 profits pool (the \$P pool) is calculated at the end of each taxable year beginning after December 31, 1986. The opening balance of the \$P pool at the beginning of the first taxable year beginning after December 31, 1986, is zero. The \$P pool is increased by the functional currency amount of the QBU branch's profits (determined under section 987) for the taxable year translated into dollars at the weighted average exchange rate (as defined in § 1.989 (b)-1) for the year. The \$P pool is decreased by the functional

currency amount of the QBU branch's losses (determined under section 987) for the taxable year translated into dollars at the weighted average exchange rate for the year and by the dollar basis of any remittances made by the QBU branch during the taxable year from the post-86 profits pool under paragraph (c)(1) of this section.

(iii) *Combination of the \$E and the \$P pools.* For taxable years beginning on or after October 25, 1991 the \$P and the \$E pools are combined into one pool called the basis pool. Additions to and subtractions from the basis pool shall be made utilizing the principles set forth in paragraphs (d)(3)(i) and (ii) of this section.

(4) *Step 3—Calculation of the dollar basis of a remittance.* For all taxable years beginning after December 31, 1986, the dollar basis of a remittance is calculated using the following formula:

$$\frac{\text{Amount of remittance (in QBU branch's functional currency) from the applicable pool (EQ, post-86 profits, or equity pool)}}{\text{Balance of the applicable pool (EQ, post-86 profits or equity pool) reduced by prior remittances}} \times \frac{\text{The dollar basis of the applicable pool (\$E, \$P, or basis pool) reduced by prior remittances}}{\text{The dollar basis of the applicable pool (\$E, \$P, or basis pool) reduced by prior remittances}}$$

(5) *Step 4—Calculation of the section 987 gain or loss on a remittance.* Section 987 gains or loss equals the difference between—

(i) The dollar amount of the remittance, and

(ii) The dollar basis of the remittance as calculated under paragraph (d)(4) of this section.

(e) *Functional currency adjusted basis of QBU branch assets acquired in taxable years beginning before January 1, 1987—*

(1) *Basis of asset.* For taxable years beginning after December 31, 1986, the functional currency adjusted basis of a QBU branch asset acquired in a taxable year beginning before January 1, 1987, is the functional currency basis of the asset at the date of acquisition, as adjusted according to United States tax principles. The functional currency adjusted basis of an asset for which a functional currency basis was not determined at the date of acquisition is

the nonfunctional currency basis of the asset at the date of acquisition multiplied by the spot exchange rate on the date of acquisition, as adjusted according to United States tax principles.

(2) *Adjustment to basis of asset.* Any future adjustments to the functional currency adjusted basis of such an asset are determined with respect to the appropriate functional currency adjusted basis of the asset as determined under this paragraph (e).

(f) *Functional currency amount of QBU branch liabilities acquired in taxable years beginning before January 1, 1987.*

For the first taxable year beginning after December 31, 1986, the amount of a QBU branch liability incurred in a taxable year beginning before January 1, 1987, is the functional currency amount of the liability at the date incurred, as adjusted according to United States tax principles. The functional currency amount of a liability for

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which a functional currency amount was not determined at the date incurred is the nonfunctional currency amount of the liability at the date incurred multiplied by the spot exchange rate on the date incurred, as adjusted according to the United States tax principles.

(g) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1: (i) *Facts.* U.S. is a domestic corporation. B, a QBU branch of U.S., operates in country X and was established in 1985. B's functional currency is the FC. U.S. is on a calendar taxable year and, prior to January 1, 1987, accounted for the operations of B by the profit and loss method of accounting as set forth in Rev. Rul. 75-107, 1975-1 C.B. 32. B's books and records were kept according to United States tax principles. B received a transfer of \$2,000 in 1985, and had profits of \$3,000 in 1985 and \$5,000 in 1986. B made a remittance in 1986, the dollar basis of which was \$1,000. As of December 31, 1986, the adjusted basis of B's functional currency assets exceeded the functional currency amount of its liabilities by 15,000 FC (the beginning pool of EQ). Under section 987, B has profits of 8,000 FC in 1987, which are worth \$1,000 when translated at the weighted average exchange rate for 1987 as required by sections 987(2) and 989(b)(4). B has no profits or loss in 1988. There are no transfers to B in 1987 and 1988. B remits 18,000 FC in 1988. Under section 987, the appropriate exchange rate for the 1988 remittance is 10 FC/\$1.

(ii) *Calculation of section 987 loss on remittance—(A) Post-86 profits.* Under paragraph (c)(i) of this section, the 18,000 FC remittance comes first out of the post-86 profits pool (8,000 FC) and second out of EQ (10,000 FC). The loss on the 1988 remittance out of the post-86 profits pool equals:

$$\begin{aligned} &\text{Dollar value of post-86 profits remitted} - \\ &\quad \text{Dollar basis of post-86 profits remitted} = \\ &(8,000 \text{ FC} \times 10 \text{ FC}/\$1) - \$1,000 = \$800 - \$1,000 \\ &= \text{<\$200> loss.} \end{aligned}$$

(B) *EQ.* Under paragraph (d) of this section, U.S. calculates 987 gain or loss on the 10,000 FC remittance of EQ from B as follows:

Step 1. The total EQ pool equals 15,000 FC (the functional currency adjusted bases of its assets less the functional currency amount of its liabilities as of December 31, 1986). There are no adjustments necessary under paragraph (d)(2)(i)(B) of this section.

Step 2. The \$E pool is \$9,000 (the \$2,000 transfer in 1985 plus profits of \$3,000 in 1985 and \$5,000 in 1986 and less than \$1,000 basis of the 1986 remittance). There are no adjustments necessary under paragraph (d)(3)(i)(B) of this section.

Step 3. The entire 10,000 FC remittance is deemed to come out of EQ.

Step 4. The dollar basis of the EQ remitted equals: N x \$E determined under paragraph (d)(3)(i)=

$$\frac{10,000 \text{ FC}}{15,000 \text{ FC}} \times \$9,000 = \$6,000$$

Where:

$$N = \frac{\text{Portion of remittance out of EQ}}{\text{EQ balance determined under paragraph (d)(2)(i) of this section}}$$

Step 5. Section 987 loss of U.S. on remittance equals:

$$\begin{aligned} &\text{Dollar value of the EQ remitted} - \text{Dollar} \\ &\quad \text{basis of the EQ remitted} = (10,000 \text{ FC} \times 10 \\ &\quad \text{FC}/\$1) - \$6,000 = \$1,000 - \$6,000 = \text{<\$5,000>} \\ &\quad \text{loss.} \end{aligned}$$

(C) *Total loss on remittance.* The total combined loss on the remittance is <\$5,200>. The total of amounts determined in paragraphs (ii)(A) and (B) of this Example 1.

Example 2: (i) *Facts.* D is a domestic corporation. B, a QBU branch of D, operates in country X. B's functional currency is the FC.

At the end of B's last taxable year beginning before October 25, 1991, B's EQ pool equals 15,000 FC and B's post-86 profits pool equals 8,000 FC. B's \$E amount equals \$9,000, and the \$P pool equals \$1,000. In B's first taxable year beginning on or after October 25, 1991, B remits 18,000 FC. Under section 987, the appropriate exchange rate for this remittance is 10FC:\$1.

(ii) *Computation of the equity pool.* 15,000 FC (EQ pool) + 8,000 FC (post-86 profits pool) = 23,000 FC (equity pool)

(iii) *Computation of the basis pool.*

$$\$9,000 (\$E \text{ amount}) + \$1,000 (\$P \text{ amount}) = \$10,000$$

(iv) *Dollar basis in remittance.*

$$\frac{18,000 \text{ FC (amount of remittance)}}{23,000 \text{ FC (equity pool)}} \times \$10,000 = \$7,826$$

(v) *Computation of section 987 loss by U.S. on remittance.*

$$\$1,800 (\text{dollar value of remittance}) - \$7,826 (\text{dollar basis in remittance}) = < \$6,026 > \\ (\text{loss on remittance})$$

(h) *Character and source of section 987 gain or loss.* Section 987 gain or loss is sourced and characterized as provided by section 987 and regulations issued under that section.

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