INTERNAL REVENUE
BULLETIN

IRS

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2025–3
January 13, 2025

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

ADMINISTRATIVE

Announcement 2025-1, page 431.

The Office of Professional Responsibility (OPR) announces recent disciplinary sanctions involving attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and appraisers. These individuals are subject to the regulations governing practice before the Internal Revenue Service (IRS), which are set out in Title 31, Code of Federal Regulations, Part 10, and which are published in pamphlet form as Treasury Department Circular No. 230. The regulations prescribe the duties and restrictions relating to such practice and prescribe the disciplinary sanctions for violating the regulations.

Notice 2025-2, page 418.

This notice provides relief from certain penalties imposed solely for failure of a partnership with unrealized receivables or inventory items to furnish Part IV of Form 8308, Report of a Sale or Exchange of Certain Partnership Interests, by January 31, 2025, to the transferor and transferee in certain transfers of partnership interests occurring in calendar year 2024.

EMPLOYEE PLANS

Notice 2025-1, page 415.

This notice sets forth updates on the corporate bond monthly yield curve, the corresponding spot segment rates for November 2024 used under § 417(e)(3)(D), the 24-month average segment rates applicable for December 2024, and the 30-year Treasury rates, as reflected by the application of § 430(h)(2)(C)(iv).

Rev. Rul. 2025-2, page 309.

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code and the Treasury Regulations thereunder, effective January 1, 2025.

INCOME TAX

Notice 2025-4, page 419.

The purpose of this notice is to announce that the Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") intend to issue proposed regulations that, for purposes of applying section 482, provide a new simplified and streamlined approach ("SSA") for pricing certain controlled transactions involving baseline marketing and distribution activities. This notice also provides guidance concerning application of the SSA to in-scope transactions undertaken by parties subject to U.S. tax with respect to those transactions before issuance of those proposed regulations.

Notice 2025-5, page 426.

This notice provides the optional 2025 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate plan. Additionally, this notice provides the maximum fair market value of employer-provided automobiles first made available to employees for personal use in calendar year 2025 for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) or the vehicle cents-per-mile valuation rule in § 1.61-21(e).

REG-117213-24, page 433.

Taxpayers are required to recognize taxable income or loss and foreign currency gain or loss with respect to a qualified business unit that has a functional currency other than the dollar. The proposed regulations include an election that is intended to reduce the compliance burden of accounting for certain disregarded transactions between a qualified business unit and its owner. This document also includes a request for comments relating to the treatment of partner-

Finding Lists begin on page ii.

ships and controlled foreign corporations. REG-117213-24. Published on December 11, 2024.

Rev. Proc. 2025-8, page 427.

This revenue procedure modifies section 7 of Rev. Proc. 2024-23, 2024-23 I.R.B. 1334, to modify the procedures under § 446 of the Internal Revenue Code and § 1.446-1(e) of the Income Tax Regulations for obtaining automatic consent of the Commissioner of Internal Revenue to change methods of accounting for research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021. The revenue procedure expands the waiver of the eligibility rules in section 5.01(1)(d) and (f) of Rev. Proc. 2015-13 to accounting method changes described in section 7.01 of Rev. Proc. 2024-23 that are made for any taxable year beginning in 2022, 2023, or 2024. This revenue procedure also permits a taxpayer to make a change under section 7.01 of Rev. Proc. 2024-23 regardless of whether the taxpayer made a change for the same item for any other taxable year beginning in 2022, 2023, or 2024.

Rev. Rul. 2025-1, page 307.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term tax exempt rate. For purposes of sections 382, 1274, 1288, 7872 and other sections of the Code, tables set forth the rates for January 2025.

T.D 10016, page 313.

Taxpayers are required to recognize taxable income or loss and foreign currency gain or loss with respect to a qualified business unit that has a functional currency other than the dollar. The final regulations provide an election to treat all items of a qualified business unit as marked items (subject to a loss suspension rule), an election to recognize all foreign currency gain or loss with respect to a qualified business unit on an annual basis, a new transition rule, and certain other rules. TD 10016 (REG-132422-17). Published on December 11, 2024.

T.D 10020, page 408.

This Treasury Decision adds final regulations under section 150 that address when tax-exempt bonds are treated as retired for purposes of sections 103 and 141 through150 (relating to requirements on tax-exempt bonds) and amends regulations under section 1001 of the Internal Revenue Code. Also, the Treasury Decision provides special rules on retirement of qualified tender option bonds and acquisition of tax-exempt bonds by guarantors of, or liquidity providers for, such bonds.

INCOME TAX, TAX CONVENTIONS

Announcement 2025-5, page 433.

The announcement confirms the suspension of the operation of paragraph 1, subparagraph (g), of Article III of the Convention between the United States of America and the Union of Soviet Socialist Republics on Matters of Taxation, with related letters, signed at Washington June 20, 1973, as it relates to Belarus, by mutual agreement.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

Part I

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 467, 468, 482, 483, 1288, 7520, 7702, 7872.)

Rev. Rul. 2025-1

This revenue ruling provides various prescribed rates for federal income tax purposes for January 2025 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. However, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Table 6 contains the deemed rate of return for transfers made during calendar year 2025 to pooled income funds described in section 642(c)(5) that have been in existence for less than 3 taxable years immediately preceding the taxable year in which the transfer was made. Finally, Table 7 contains the average of the applicable federal mid-term rates (based on annual compounding) for the 60-month period ending December 31, 2024, for purposes of section 7702(f)(11).

REV. RUL. 2025-1 TABLE 1
Applicable Federal Rates (AFR) for January 2025
Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
		Short-term		
AFR	4.33%	4.28%	4.26%	4.24%
110% AFR	4.77%	4.71%	4.68%	4.66%
120% AFR	5.21%	5.14%	5.11%	5.09%
130% AFR	5.64%	5.56%	5.52%	5.50%
		Mid-term		
AFR	4.24%	4.20%	4.18%	4.16%
110% AFR	4.67%	4.62%	4.59%	4.58%
120% AFR	5.10%	5.04%	5.01%	4.99%
130% AFR	5.53%	5.46%	5.42%	5.40%
150% AFR	6.40%	6.30%	6.25%	6.22%
175% AFR	7.49%	7.35%	7.28%	7.24%
		Long-term		
AFR	4.53%	4.48%	4.46%	4.44%
110% AFR	4.99%	4.93%	4.90%	4.88%
120% AFR	5.45%	5.38%	5.34%	5.32%
130% AFR	5.90%	5.82%	5.78%	5.75%

REV. RUL. 2025-1 TABLE 2
Adjusted AFR for January 2025
Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.28%	3.25%	3.24%	3.23%
Mid-term adjusted AFR	3.22%	3.19%	3.18%	3.17%
Long-term adjusted AFR	3.43%	3.40%	3.39%	3.38%

REV. RUL. 2025-1 TABLE 3 Rates Under Section 382 for January 2025	
Adjusted federal long-term rate for the current month	3.43%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	3.43%

REV. RUL. 2025-1 TABLE 4 Appropriate Percentages Under Section 42(b)(1) for January 2025	
Note: Under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%.	
Appropriate percentage for the 70% present value low-income housing credit	8.02%
Appropriate percentage for the 30% present value low-income housing credit	3.44%

REV. RUL. 2025-1 TABLE 5 Rate Under Section 7520 for January 2025	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.2%

REV. RUL. 2025-1 TABLE 6 Deemed Rate for Transfers to New Pooled Income Funds During 2025	
Deemed rate of return for transfers during 2025 to pooled income funds that have been in existence for less than 3 taxable years	4.0%

REV. RUL. 2025-1 TABLE 7 Average of the Applicable Federal Mid-Term Rates for 2024
For purposes of section 7702(f)(11), the average of the applicable federal mid-term rates (based on annual compounding) for the 60-month period ending December 31, 2024, is 2.53% rounded to 3%.

Section 42.—Low-Income Housing Credit

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 280G.—Golden Parachute Payments

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 467.—Certain Payments for the Use of Property or Services

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The applicable federal short-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 482.—Allocation of Income and Deductions Among Taxpayers

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 483.—Interest on Certain Deferred Payments

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 7520.—Valuation Tables

The applicable federal mid-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 7702.—Life Insurance Contract Defined

The average of the applicable federal mid-term rates for the 60-month period ending December 31, 2024, for purposes of section 7702(f)(11). See Rev. Rul. 2025-1, page 307.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2025. See Rev. Rul. 2025-1, page 307.

Section 401. — Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401(l)-1: Permitted disparity in employer-provided contributions or benefits

Rev. Rul. 2025-2

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code (“Code”) and the Treasury Regulations thereunder, for the 2025 plan year.

Section 401(l)(5)(E)(i) defines covered compensation with respect to an employee as the average of the contribution and benefit bases in effect under section 230 of the Social Security Act (“Act”) for each year in the 35-year period ending with the year in which the employee attains Social Security retirement age.

Section 401(l)(5)(E)(ii) of the Code states that the determination for any year preceding the year in which the employee attains Social Security retirement age shall be made by assuming that there is no increase in covered compensation after the determination year and before the employee attains Social Security retirement age.

Treas. Reg. § 1.401(l)-1(c)(34) defines the taxable wage base as the contribution and benefit base under section 230 of the Act.

Section 1.401(l)-1(c)(7)(i) defines covered compensation for an employee as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) Social Security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee’s covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year. An employee’s covered compensation for a plan year beginning after the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the employee’s covered compensation for a plan year during which the 35-year period ends. An employee’s covered compensation for a plan year beginning before the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

Section 1.401(l)-1(c)(7)(ii) provides that, for purposes of determining the amount of an employee’s covered compensation under § 1.401(l)-1(c)(7)(i), a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

For purposes of determining covered compensation for the 2025 plan year, the taxable wage base is $176,100.

The following tables provide covered compensation for 2025.

ATTACHMENT I

2025 UNROUNDED COVERED COMPENSATION TABLE

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	2025 COVERED COMPENSATION UNROUNDED
1907	1972	$ 4,488
1908	1973	4,704
1909	1974	5,004
1910	1975	5,316
1911	1976	5,664
1912	1977	6,060
1913	1978	6,480
1914	1979	7,044
1915	1980	7,692
1916	1981	8,460
1917	1982	9,300
1918	1983	10,236
1919	1984	11,232
1920	1985	12,276
1921	1986	13,368
1922	1987	14,520
1923	1988	15,708
1924	1989	16,968
1925	1990	18,312
1926	1991	19,728
1927	1992	21,192
1928	1993	22,716
1929	1994	24,312
1930	1995	25,920
1931	1996	27,576
1932	1997	29,304
1933	1998	31,128
1934	1999	33,060
1935	2000	35,100
1936	2001	37,212
1937	2002	39,444
1938	2004	43,992
1939	2005	46,344
1940	2006	48,816
1941	2007	51,348
1942	2008	53,952
1943	2009	56,628
1944	2010	59,268
1945	2011	61,884
1946	2012	64,560
1947	2013	67,308

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	2025 COVERED COMPENSATION UNROUNDED
1948	2014	69,996
1949	2015	72,636
1950	2016	75,180
1951	2017	77,880
1952	2018	80,532
1953	2019	83,244
1954	2020	86,052
1955	2022	91,884
1956	2023	95,172
1957	2024	98,616
1958	2025	102,180
1959	2026	105,684
1960	2027	109,140
1961	2028	112,524
1962	2029	115,824
1963	2030	119,100
1964	2031	122,340
1965	2032	125,508
1966	2033	128,580
1967	2034	131,544
1968	2035	134,400
1969	2036	137,124
1970	2037	139,740
1971	2038	142,284
1972	2039	144,804
1973	2040	147,264
1974	2041	149,604
1975	2042	151,848
1976	2043	153,960
1977	2044	155,940
1978	2045	157,920
1979	2046	159,900
1980	2047	161,784
1981	2048	163,572
1982	2049	165,264
1983	2050	166,908
1984	2051	168,552
1985	2052	169,944
1986	2053	171,312
1987	2054	172,548
1988	2055	173,640
1989	2056	174,600
1990	2057	175,428
1991	2058	175,884
1992 and Later	2059 and Later	176,100

ATTACHMENT II

2025 ROUNDED COVERED COMPENSATION TABLE

CALENDAR YEAR OF BIRTH	2025 COVERED COMPENSATION ROUNDED
1937	$ 39,000
1938 – 1939	45,000
1940	48,000
1941	51,000
1942	54,000
1943	57,000
1944	60,000
1945	63,000
1946 – 1947	66,000
1948	69,000
1949	72,000
1950	75,000
1951	78,000
1952	81,000
1953	84,000
1954	87,000
1955	93,000
1956	96,000
1957	99,000
1958	102,000
1959	105,000
1960	108,000
1961	114,000
1962	117,000
1963	120,000
1964	123,000
1965	126,000
1966	129,000
1967	132,000
1968	135,000
1969	138,000
1970 – 1971	141,000
1972	144,000
1973	147,000
1974	150,000
1975 – 1976	153,000
1977	156,000
1978 – 1979	159,000
1980	162,000

CALENDAR YEAR OF BIRTH	2025 COVERED COMPENSATION ROUNDED
1981 – 1982	165,000
1983 – 1984	168,000
1985 – 1986	171,000
1987 – 1989	174,000
1990 and Later	176,100

DRAFTING INFORMATION

The principal author of this revenue ruling is Tom Morgan of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the IRS participated in the development of this guidance. For further information regarding this revenue ruling, contact Mr. Morgan at 202-317-6700 (not a toll-free number).

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26 CFR 1.987-0 through 26 CFR 1.987-15

T.D. 10016

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Taxable Income or Loss and Currency Gain or Loss with Respect to a Qualified Business Unit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final rule.

SUMMARY: This document contains final regulations relating to the determination of taxable income or loss and foreign currency gain or loss with respect to a qualified business unit. These final regulations include an election to treat all items of a qualified business unit as marked items (subject to a loss suspension rule), an election to recognize all foreign currency gain or loss with respect to a qualified business unit on an annual basis, and a new transition rule.

DATES: *Effective date*: The final regulations are effective December 10, 2024.

Applicability dates: For dates of applicability, *see* §1.987-15.

FOR FURTHER INFORMATION CONTACT: Concerning the final regulations generally, Adam G. Province at (865) 329-4546; concerning the character and source of section 987 gain or loss, Larry Pounders at (202) 317-5465; concerning consolidated groups, Jeremy Aron-Dine at (202) 317-6847 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Authority

This document contains additions and amendments to 26 CFR part 1 (Income Tax Regulations) addressing the application of section 987 of the Internal Revenue Code (Code) and related provisions (the "final regulations"). The additions and amendments are issued under sections 987, 989, and 1502, pursuant to the express delegations of authority provided under those sections. The express delegations relied upon are referenced in the Background section of this preamble and in the Summary of Comments and Explanation of Revisions describing the individual sections of the final regulations. The final regulations are also issued under the express delegation of authority under section 7805 of the Code.

Background

This document contains final regulations under section 987 of the Code and related provisions under sections 861, 985 through 989, and 1502 of the Code. Section 987 applies to any taxpayer that has a qualified business unit ("QBU") with a functional currency other than the dollar. Section 987(1) and (2) provide rules for determining and translating taxable income or loss ("section 987 taxable income or loss") with respect to the QBU. In addition, foreign currency gain or loss must be determined under section 987(3) ("section 987 gain or loss"), which requires proper adjustments (as prescribed by the Secretary) for transfers of property between QBUs of the taxpayer having different functional currencies.

Sections 987 and 989 provide several explicit grants of regulatory authority. Section 987(3) directs the Secretary to prescribe the proper adjustments needed to determine the taxable income of the owner of a section 987 QBU. Those adjustments include (but are not limited to) rules for sourcing section 987 gain or loss recognized under section 987(3)(B). Similarly, section 987(2) provides that the income of a QBU is translated at the "appropriate" exchange rate. Section 989(b)(4) provides that the appropriate exchange rate generally is the average rate for the taxable year, "except as provided in regulations."

Section 989(c) directs the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subpart."[1] The grant of authority in section 989(c) includes regulations limiting the recognition of foreign currency loss on certain remittances from QBUs, providing for the appropriate

[1] The reference to "this subpart" refers to subpart J of part III of subchapter N of chapter 1 of the Code, which includes section 987.

treatment of related party transactions (including transactions between QBUs of the same taxpayer), and setting forth procedures for determining the average exchange rate for any period. Section 989(c)(2), (5), and (6).

On December 8, 2016, the Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") published Treasury Decision 9794, which contained final regulations under sections 861, 985, 987, 988, and 989 (the "2016 final regulations"), in the **Federal Register** (81 FR 88806). The same day, the Treasury Department and the IRS published Treasury Decision 9795, which contained temporary regulations under sections 987 and 988 (the "2016 temporary regulations"), in the **Federal Register** (81 FR 88854) and published a notice of proposed rulemaking (REG-128276-12, 81 FR 88882) (the "2016 proposed regulations") in the **Federal Register** by cross-reference to the temporary regulations. On May 13, 2019, the Treasury Department and the IRS published Treasury Decision 9857, which contained final regulations under section 987 (the "2019 final regulations"), in the **Federal Register** (84 FR 20790).

On November 14, 2023, the Treasury Department and the IRS published proposed regulations (REG-132422-17) under sections 861, 985, 987, 988, 989, and 1502 of the Code (the "2023 proposed regulations") in the **Federal Register** (88 FR 78134). The same day, the Treasury Department and the IRS also published a notice in the **Federal Register** (88 FR 77921) that reopened the comment period for the 2016 proposed regulations.

All written comments received in response to the 2016 proposed regulations and the 2023 proposed regulations are available at https://www.regulations.gov or upon request. A public hearing on the 2023 proposed regulations was not held because there were no requests to speak.

Concurrently with the publication of the final regulations, the Treasury Department and the IRS are publishing in the proposed rule section of this edition of the **Federal Register** (RIN 1545-BR37) a notice of proposed rulemaking providing additional proposed regulations under section 987 (REG-117213-24) (the "2024 proposed regulations").

Summary of Comments and Explanation of Revisions

I. Overview

The Treasury Department and the IRS received a number of written comments in response to the 2016 proposed regulations and the 2023 proposed regulations. The comments, and the revisions made in response to those comments, are summarized in this Summary of Comments and Explanation of Revisions.

The final regulations retain the basic approach and structure of the 2023 proposed regulations, with the revisions described in this Summary of Comments and Explanation of Revisions.

II. Comments and Changes to Proposed §1.987-1: Scope, Definitions, and Special Rules

Proposed §1.987-1 would provide rules regarding the scope of the regulations under section 987 ("section 987 regulations"), including which entities are subject to the regulations, rules relating to elections under section 987, and other rules.

A. *Scope*

Under proposed §1.987-1(b)(1), the section 987 regulations would apply to all taxpayers, subject to a de minimis rule for pass-through entities with minimal U.S. ownership, but they would not apply to foreign individuals or foreign corporations that either are not controlled foreign corporations ("CFCs") or are CFCs in which no United States shareholders ("U.S. shareholders") own (within the meaning of section 958(a)) stock. In contrast to the 2016 final regulations, the 2023 proposed regulations would not provide an exception for banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, or real estate investment trusts ("specified entities"). The preamble to the 2023 proposed regulations explains that the current rate election and annual recognition election are expected to provide additional flexibility for specified entities to apply the section 987 regulations. 88 FR 78145. Taxpayers that make a current rate election would treat all assets and liabilities attributable to a section 987 QBU as marked items, and thus would not be required to track historic exchange rates. Taxpayers that make an annual recognition election would recognize all unrecognized section 987 gain or loss on an annual basis and would not be required to calculate the amount of a remittance with respect to a section 987 QBU under §1.987-5. *See* parts II and IV of the Explanation of Provisions in the preamble to the 2023 proposed regulations. 88 FR 78138 through 78139, 78141 through 78143. In addition, including specified entities in the scope of the section 987 regulations is necessary to provide these entities with sufficient guidance under section 987 and to provide a consistent set of rules applicable to all taxpayers.

1. Specified entities

Comments recommended that specified entities be excluded from the application of the section 987 regulations. The comments asserted that additional rules are needed to facilitate the application of the section 987 regulations to these entities. For example, according to the comments, it is unclear whether insurance reserves should be treated as marked items or historic items. A comment also noted that bank branches often engage in high volumes of intercompany transactions that could be difficult to account for under the section 987 regulations.

The Treasury Department and the IRS have determined that the final regulations can be applied by specified entities in an administrable manner and that excluding specified entities from the scope of the section 987 regulations would not provide sufficient guidance to ensure that these entities are using an appropriate method to apply section 987. Moreover, section 987 and its legislative history give no indication that Congress intended for banks, insurance companies, and other specified entities to be treated differently from other taxpayers for this purpose. Accordingly, specified entities are subject to the final regulations. However, the final regulations contain modifications intended to facilitate application of the section 987 regulations to these entities. *See* parts II.B (rules relating to insurance companies), V.B (hedging transactions), and VI (modifications to annual remittance rules to reduce the burden of tracking disregarded transfers) of this Summary of Comments and Explanation of Revisions.

2. Partnerships and certain other entities

One comment was received relating to the application of section 987 to partnerships, and the Treasury Department and the IRS continue to study this issue. The Treasury Department and the IRS have determined that, without additional guidance, the section 987 regulations in their entirety could not be applied to partnerships in an administrable way. Accordingly, the final regulations generally apply only with respect to corporations and individuals. However, as discussed in part VIII of this Summary of Comments and Explanation of Revisions, certain parts of the section 987 regulations (including the rules relating to suspension of section 987 loss and recognition of suspended section 987 loss) are applicable to partnerships and S corporations.

The section 987 regulations do not apply to trusts or estates (though trusts and estates can be subject to section 987) because additional guidance may be needed to apply section 987 to these entities. In particular, the Treasury Department and the IRS are studying whether specific rules are needed to address the apportionment of section 987 gain or loss between the estate or non-grantor trust and the beneficiaries or whether existing rules under section 643(a) (defining distributable net income of an estate or trust) sufficiently address this issue. In addition, specific rules may be needed to address a beneficiary's application of section 987 with respect to an estate or non-grantor trust that uses a different functional currency (which creates a separate layer of currency exposure). The Treasury Department and the IRS anticipate providing rules applicable to trusts and estates in future guidance.

3. Application to CFCs

The final regulations apply to individuals and corporations that are United States persons ("U.S. persons") and to CFCs in which U.S. shareholders own stock (directly or indirectly within the meaning of section 958(a)). *See* §1.987-1(b)(1). As explained in parts II.A.2 and VIII of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS are continuing to study the appropriate rules for applying section 987 to partnerships.

A comment recommended that the scope of the section 987 regulations be limited to section 987 QBUs owned directly by U.S. persons or by partnerships with partners that are U.S. persons. According to the comment, this would reduce the compliance burden on taxpayers and prevent the selective recognition of section 987 losses. The comment further asserted that, based on the legislative history of section 987(3), the statute primarily was intended to address section 987 QBUs owned by U.S. persons.

The comment suggested that simplified mechanics under section 986(c) could be used to account for currency gain or loss arising between the time earnings are generated by a section 987 QBU and the time of distribution, but the comment did not explain how those mechanics would operate. Section 986(c) requires a U.S. shareholder to recognize foreign currency gain or loss with respect to distributions of previously taxed earnings and profits attributable to movements in exchange rates between the date of the income inclusion giving rise to the previously taxed earnings and profits and the distribution of the previously taxed earnings and profits.

The final regulations do not adopt the recommendations made by the comment. It is necessary to apply section 987(1) and (2) to foreign entities because many aspects of the income tax rules effectively require that the determination of a taxpayer's items of income, gain, deduction, and loss be made in a single currency. In addition, it is not clear how a rule similar to section 986(c) could be applied to section 987 QBUs in lieu of section 987(3). Because a CFC's earnings and profits are determined in the CFC's functional currency under section 986(b), currency gain or loss on previously taxed earnings and profits arises under section 986(c) when a CFC's functional currency appreciates or depreciates against the U.S. dollar between the time the inclusion is computed and the time the CFC distributes the previously taxed earnings and profits. However, section 986(c) would not account for changes in value of a section 987 QBU's functional currency (measured against the functional currency of its CFC-owner or the U.S. shareholder) because earnings and profits are not tracked in the section 987 QBU's functional currency.

However, the Treasury Department and the IRS are studying whether there are instances in which it would be possible to simplify the application of section 987 by modifying the application of section 987(3) (and the related regulations, including §§1.987-4 through 1.987-6, 1.987-8, and 1.987-11 through 1.987-13) to certain entities. *See* part II.B of the Comments and Request for Public Hearing section in the preamble to the 2024 proposed regulations.

B. *Special Rules for Insurance Companies*

1. Insurance reserves

A comment requested clarification as to whether insurance reserves are treated as marked items. The comment noted that the definition of a marked item under the proposed regulations is tied to the treatment of an asset or liability under section 988 and that the application of section 988 to insurance reserves is not clear. The Treasury Department and the IRS agree that treating insurance reserves as marked items would facilitate the application of section 987 to insurance companies and would be consistent with the treatment of liabilities outside the insurance context. Accordingly, §1.987-1(d)(1)(iv) includes insurance reserves in the definition of marked items.

2. Assets that support variable contracts

a. Background on variable contracts

In general, variable contracts are life insurance and annuity contracts under which the amount of the insurance company's obligation depends, at least in part, on the value of the assets held in a separate account that is segregated from the general asset accounts of the insurance company. Provided certain requirements are met, under section 817(c), an insurance company that issues variable contracts (as defined in section 817(d)) must separately account for the various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts.

As a general matter, section 807 provides that increases in the life insurance reserves of a life insurance company are deductible and decreases in the life insurance reserves are includible in income. However, section 817(a) provides that for purposes of determining the net decrease or increase in reserves under section 807(a) or (b), amounts subtracted from or added to separate account reserves by reason of the depreciation or appreciation of separate account assets (whether or not realized) are disregarded. Under section 817(a), deductions for items described in section 805(a)(1) and (6), which include claims and benefits accrued and losses incurred during the taxable year on insurance and annuity contracts, are similarly adjusted for the depreciation or appreciation of separate account assets. Additionally, section 817(b) provides that the basis of each separate account asset is decreased by the amount of depreciation, or increased by the amount of appreciation, of separate account assets (whether or not realized), to the extent separate account reserves are adjusted for such depreciation or appreciation under section 817(a). Generally, the result is a permanent elimination of any effects on company-level taxable income that would otherwise result from the change in the value of the separate account assets.

Sometimes, however, an insurance company may provide guarantees with respect to variable contracts with separate accounts that could require reserves to be held in a company's general account. Section 817(d)(3) recognizes this situation and states that "obligations under such guarantee which exceed obligations under the contract without regard to such guarantee shall be accounted for as part of the company's general account." Such guarantees might involve a limit on losses or guarantees of minimum crediting rates. These amounts are not liabilities of the separate account.

Similarly, CFCs generally must follow the Code and subchapter L rules in determining their insurance income, with minor modifications for determining: (i) whether a contract is a life insurance or annuity contract, and (ii) the amount of insurance reserves. For example, U.S. tax requirements in sections 72(s), 101(f), 817(h), and 7702 do not apply so long as no policyholder, annuitant, insured, or beneficiary under the contract is a United States person and the contract is regulated as a life insurance or annuity contract in the issuer's home country. In addition, section 954(i) modifies the subchapter L computation of insurance reserves and its application to insurance contracts issued by CFCs. *See also* section 953(b)(3).

b. Treatment of assets that support variable contracts for purposes of section 987

A comment recommended that assets which support variable annuity and life insurance contracts be treated as marked items. The comment explained that these assets are required by law to be segregated from the general asset accounts of the insurance company in a separate account, and the related contracts reflect the investment return and market value of the separate account assets.

The comment asserted that both the separate account assets and the related insurance reserves should be treated as marked items in order to align the treatment of these assets and liabilities for purposes of section 987. Similarly, the comment recommended that these assets and liabilities should be treated as attributable to an eligible QBU if they are reflected on the books and records of the eligible QBU, even if they would otherwise be excluded under §1.987-2(b)(2) (for example, if the separate account assets consist of stock or partnership interests).

The final regulations provide that separate account assets are treated as marked items. *See* §1.987-1(d)(1)(v). In addition, the final regulations carve out separate account assets from the exclusions in §1.987-2(b)(2), so that separate account assets reflected on the books and records of an eligible QBU generally will be attributable to the eligible QBU. *See* §1.987-2(b)(2)(ii). These rules are expected to facilitate matching treatment of separate account assets and the related insurance contracts, consistent with the treatment of these items for statutory and financial accounting purposes and the nature of the issuer's economic obligations.

The final regulations define a separate account asset as an asset that is reflected on the books and records of an eligible QBU and is held in a separate account with respect to a separate account insurance contract. *See* §1.987-1(h). A separate account insurance contract generally is defined as a contract that would be treated as an insurance contract for Federal income tax purposes for which the assets supporting the insurance reserves are required to be held in a separate account under the local insurance regulatory rules. In addition, the contract generally must qualify as a variable contract under section 817(d). However, if the contract does not qualify as a variable contract under section 817(d) solely because it fails to meet one or more of the requirements in section 72(s), 101(f), 817(h), or 7702, the contract will be treated as a separate account insurance contract if it is regulated as a life insurance or annuity contract under foreign law, the contract reserves are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest (treating the reflection of the investment return and the market value of assets in the separate account as an assumed rate of interest), and no policyholder, annuitant, insured, or beneficiary under the contract is a United States person. These requirements are consistent with the requirements for life insurance or annuity contracts issued by CFCs.

3. Assets of an insurance company that produce financial services income

A comment recommended that assets of an insurance company that produce financial services income (within the meaning of section 904(d)(2)(D)(ii)(II) and (III)) should be treated as marked items. The comment asserted that the assets insurance companies hold to support insurance obligations are closely matched to those obligations and that concerns related to the selective recognition of large noneconomic losses under section 987 are not present for insurance companies.

The final regulations do not treat all assets that produce financial services income as marked assets. As a result, those assets are classified as marked or historic under the general rules of §1.987-1(d) or (e). The definition of a marked item under §1.987-1(d)(1) is intended to identify those items of a section 987 QBU that are directly exposed to changes in the value of a section 987 QBU's functional currency. This definition is designed to ensure that, in the absence of a current rate election, section 987 gain or loss recognized by the owner of a section 987 QBU represents bona fide economic gain or loss. To the extent that a section 987 QBU of an insurance company holds assets that are not directly exposed to exchange rate fluctuations (for example, publicly traded stock), and a current rate election is not in effect, those assets are properly characterized as historic items even if they generate financial services income.

4. Deferred acquisition costs

A comment recommended that the unamortized portion of specified policy acquisition expenses (as defined in section 848) should be treated as marked items. These specified policy acquisition expenses are generally a specified portion of general deductions and represent deferred acquisition costs. The comment noted that specified policy acquisition expenses are akin to prepaid expenses and the amount and timing of the related deductions are determined under insurance-specific tax rules.

The final regulations do not treat the unamortized portion of specified policy acquisition expenses as marked items. Although certain prepaid expenses are treated as marked items under §1.987-1(d)(1)(ii), that rule applies only to prepaid expenses with an original term of one year or less. The preamble to the 2016 final regulations explains that, because these prepaid expenses have a short duration and often are small in amount, treating them as marked items promotes administrability without creating significant distortions. 81 FR 88810. By contrast, specified policy acquisition expenses under section 848 generally are amortized over a period of 15 years and can be substantial in magnitude. Thus, if specified policy acquisition expenses were treated as marked items, they could give rise to significant amounts of non-economic section 987 gain or loss.

C. *Elections*

The 2023 proposed regulations would provide that a current rate election or an annual recognition election may not be revoked without consent for any taxable year beginning within 60 months of the first day of the taxable year for which it was made. Proposed §1.987-1(g)(3)(ii)(B). Once revoked, a new current rate election or annual recognition election may not be made without consent for any taxable year beginning within 60 months of the first day of the taxable year for which it was revoked. *Id.*

A comment recommended that, during the first five years in which the section 987 regulations are applicable, taxpayers should be allowed to make or revoke a current rate election without waiting 60 months or requesting consent. The comment noted that taxpayers may need more flexibility to reassess their elections during this initial period because they do not yet have sufficient information or experience regarding the impact of making (or not making) a current rate election.

The final regulations retain the 60-month limitation for taxpayers that make a current rate election or an annual recognition election and apply a similar limitation for purposes of the section 988 mark-to-market election (*see* part IV.C.1 of this Summary of Comments and Explanation of Revisions). Permitting taxpayers to make or revoke elections on a more frequent basis could increase the potential for manipulation and abuse. However, taxpayers that wish to change their elections without waiting 60 months can do so by requesting the Commissioner's consent, and the Commissioner may consider the need for additional flexibility on a case-by-case basis.

D. *No Change in Method of Accounting*

Proposed §1.987-1(g)(4) provides that elections under section 987 are not governed by the general rules concerning changes in methods of accounting. In addition, the final regulations clarify that an election under section 987 is not treated as a method of accounting for purposes of section 446 or 481. *See* §1.987-1(g)(4). Similarly, the final regulations provide that application of the transition rules under §1.987-10 is not treated as a change in method of accounting. *See* §1.987-10(k)(4). No inference is intended as to whether a change in section 987 methodology is considered a change in method of accounting before the final regulations become applicable (or with respect to partnerships or other entities that are not generally subject to the section 987 regulations).

III. Comments and Changes to Proposed §1.987-2: Attribution of Items of an Eligible QBU, the Definition of a Transfer, and Related Rules

Proposed §1.987-2 provides rules for attributing items to eligible QBUs and rules relating to transfers of assets or liabilities to or from eligible QBUs.

A. *Attribution of Items to an Eligible QBU*

Under the proposed regulations, items are attributable to an eligible QBU to the extent they are reflected on the eligible QBU's separate set of books and records. Proposed §1.987-2(b)(1). The final regulations clarify that an item that is not taken into account for financial accounting purposes is attributed to an eligible QBU to the extent it would have been reflected on the eligible QBU's books and records if it were taken into account for financial accounting purposes (for example, amortization attributable to an item of intangible property that is recognized and taken into account for tax purposes due to a section 338 election, but is not recognized or taken into account for financial reporting purposes). *See* §1.987-2(b)(1). Similarly, in preparing an adjusted balance sheet for a section 987 QBU, the owner must make adjustments to reflect items that were not reflected on the section 987 QBU's books and records for the taxable year but should be so reflected under United States tax accounting principles. *See* §1.987-1(h). No inference should be drawn from this clarification with respect to other similar rules that attribute items based on books and records including under §1.904-4(f) (foreign branch category income) or §1.1503(d)-5(c) (income or dual consolidated loss of a separate unit).

B. *Disregarded Transactions*

Under proposed §1.987-2(c)(2)(i), an asset is treated as transferred to a section 987 QBU from its owner if, as a result of a disregarded transaction, the asset is reflected on the books and records of (or attributable to) the section 987 QBU. Similarly, an asset is treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, the asset ceases to be reflected on (or attributable to) the books and records of the section 987 QBU. However, disregarded transactions do not give rise to items of income, gain, deduction, or loss that are taken into account in determining section 987 taxable income or loss under §1.987-3. Proposed §1.987-2(c)(2)(iii).

A comment recommended that interbranch loans made by banks and other regulated financial institutions should not be treated as transfers for purposes of determining the amount of a remittance under §1.987-5(c). The comment asserted that an interbranch loan is not a permanent transfer because the borrower has an obligation to repay the lender. Another comment requested that the final regulations conform the treatment of disregarded transactions for purposes of section 987 with the reattribution rules provided in §1.904-4(f)(2)(vi). Under this approach, disregarded payments would result in the reattribution of items of gross income between a section 987 QBU and its owner and between separate 987 QBUs of the same owner, and they would not be treated as transfers giving rise to the recognition of section 987 gain or loss. The comment noted that, under proposed §1.987-2(c)(2), a disregarded payment for services or a sale of inventory (including a payment from one section 987 QBU to a different section 987 QBU with the same functional currency) could give rise to a remittance even though there is no net economic transfer of value. Further, because disregarded transactions do not give rise to section 987 taxable income or loss under proposed §1.987-2(c)(2)(iii), the comment asserted that the amount of section 987 taxable income or loss may be different from the amount of income that is economically attributable to the section 987 QBU.

The final regulations retain the disregarded transaction rules of proposed §1.987-2(c). *See* §1.987-2(c). These rules are needed to properly account for the effect of a disregarded transaction on the balance sheet of a section 987 QBU for purposes of determining the owner's net unrecognized section 987 gain or loss under §1.987-4, the amount of a remittance under §1.987-5(c), and to properly determine the owner's basis in transferred assets under §1.987-5(f).

In the case of a disregarded lending transaction in which a section 987 QBU lends money to its owner, although the owner remains obligated to repay the borrowed funds, the disregarded loan is not an asset that can be attributed to the QBU for tax purposes. Accordingly, for tax purposes, the QBU-lender's balance sheet is diminished by the amount of the loan in the same way as any other transfer from the QBU to its owner. To the extent the loan is funded and repaid within the same taxable year, the two transfers will offset in computing the remittance amount under §1.987-5(c). However, when a disregarded loan spans multiple taxable years, the owner must account for the effect of the transaction on the net equity of the section 987 QBU (as regarded for tax purposes).

In addition, the final regulations do not provide for reattribution of gross income between a section 987 QBU and its owner or between section 987 QBUs of the same owner for purposes of section 987. When a section 987 QBU makes a disregarded payment to its owner, the payment properly triggers the recognition of section 987 gain or loss because the transferred asset has been withdrawn from the QBU and is no longer accounted for in the section 987 QBU's functional currency. Even if the transaction does not reduce the economic value of the section 987 QBU on a net basis (for example, because the disregarded payment is made in exchange for services of equal value), it nonetheless results in a net withdrawal of asset basis from the functional currency environment of the section 987 QBU and is therefore properly treated as a remittance for purposes of section 987. Moreover, a rule determining the amount of a remittance based on the value of property transferred from a section 987 QBU would be difficult to administer and prone to manipulation.

Similarly, because disregarded transactions do not give rise to taxable income or loss under general tax principles, they are not taken into account in determining section 987 taxable income or loss. *See* §1.987-2(c)(2)(iii). Instead, the regarded income of an owner that is properly reflected on the books and records of (or attributable to) a section 987 QBU under §1.987-2(b) is determined in the functional currency of the section 987 QBU and translated into the owner's functional currency under the rules of §1.987-3. Disregarded payments do not serve to reattribute gross income between a section 987 QBU and its owner for purposes of determining section 987 taxable income or loss. Such a reattribution rule would add complexity to the section 987 regulations (for example, when income is reattributed in a taxable year following the taxable year in which the disregarded payment is made), and it would not serve any necessary function.

However, the final regulations contain targeted modifications that are intended to reduce the compliance burden of accounting for certain transfers between a section 987 QBU and its owner. *See* part VI of this Summary of Comments and Explanation of Revisions (describing modifications to the annual remittance rules to reduce the burden of tracking and translating disregarded transfers). Additionally, if an owner elects to group section 987 QBUs with the same functional currency under §1.987-1(b)(3)(ii), transactions between the section 987 QBUs will not be treated as transfers between the section 987 QBUs and their owner for purposes of section 987.

IV. Comments and Changes to Proposed §1.987-3: Determination of Section 987 Taxable Income or Loss of an Owner of a Section 987 QBU

Proposed §1.987-3 would provide rules for determining taxable income or loss of a section 987 QBU, including section 988 transactions of a section 987 QBU. Additional rules relating to section 988 transactions would be provided in §1.987-3 of the 2016 proposed regulations, for which the comment period was reopened in 2023.

A. *Treatment of Section 988 Transactions Under the 2016 Proposed Regulations*

The 2016 proposed regulations provide that the determination of whether a transaction is a section 988 transaction is made by reference to the section 987 QBU's functional currency. Thus, a transaction otherwise within the scope of section 988 that is denominated in a functional currency other than the section 987 QBU's functional currency generally would be treated as a section 988 transaction. *See* §1.987-3(b)(4)(i) of the 2016 proposed regulations. However, section 988 transactions of a section 987 QBU denominated in, or determined by reference to, the owner's functional currency ("specified owner functional currency transactions") would not be treated as section 988 transactions of the section 987 QBU. *See* §1.987-3(b)(4)(ii) of the 2016 proposed regulations.

The 2016 proposed regulations would further provide that section 988 gain or loss of a section 987 QBU generally is determined by reference to the owner's functional currency. *See* §1.987-3(b)(4)(i) of the 2016 proposed regulations. However, section 988 gain or loss with respect to certain short-term section 988 transactions ("qualified short-term section 988 transactions") accounted for under a mark-to-market method of accounting would be determined in the functional currency of the section 987 QBU, and not the functional currency of its owner. *See* §1.987-3(b)(4)(iii) of the 2016 proposed regulations. The 2016 proposed regulations would provide an election under which taxpayers can apply a mark-to-market method of accounting with respect to all qualified short-term section 988 transactions. *See* §1.987-3(b)(4)(iii)(C) of the 2016 proposed regulations.

Under the 2016 final regulations (and the 2023 proposed regulations), a transaction denominated in a currency other than the section 987 QBU's functional currency is treated as a historic item. *See* §1.987-1(d) and (e). However, the 2016 proposed regulations provide an exception under which a qualified short-term section 988 transaction for which section 988 gain or loss is determined by reference to the functional currency of the section 987 QBU is a marked item. *See* §1.987-1(d)(3) of the 2016 proposed regulations.

The preamble to the 2023 proposed regulations requested comments as to whether section 988 gain or loss on nonfunctional currency transactions of a section 987 QBU (including specified owner functional currency transactions) should be determined in the functional currency of the section 987 QBU when a current rate election or annual recognition election is in effect. 88 FR 78154. The preamble expressed concern that, if such a rule were adopted, specified owner functional currency transactions would give rise to offsetting positions in the functional currency of the section 987 QBU; this could create opportunities for taxpayers to recognize losses while deferring the offsetting gains. *Id.* For example, if a section 987 QBU held assets denominated in its owner's functional currency, and the section 987 QBU's functional currency weakened against that of its owner, the section 987 QBU would have unrecognized section 988 gain and the owner would have an inverse amount of unrecognized section 987 loss. The owner could cause the QBU to make a remittance triggering the recognition of section 987 loss, while deferring the section 988 gain.

B. *Comments on the 2023 Proposed Regulations Regarding Section 988 Transactions of Section 987 QBUs*

Comments asserted that the section 988 rules of the 2016 proposed regulations would impose a substantial compliance burden on taxpayers. The comments noted that for financial accounting purposes, foreign currency gain or loss on nonfunctional currency transactions of a QBU is measured by reference to the functional currency of the QBU. In addition, taxpayers typically hedge their exposure to nonfunctional currency transactions of a QBU by reference to the QBU's functional currency. One comment noted that it is common for section 987 QBUs of insurance companies to hold assets denominated in U.S. dollars for commercial reasons and that treating these assets as historic items would increase the compliance burden on insurance companies.

Comments suggested that the rules of the 2016 proposed regulations be modified to provide that: (i) section 988 gain or loss on nonfunctional currency transactions of a section 987 QBU is determined by reference to the functional currency of the section 987 QBU, (ii) specified owner functional currency transactions are treated as section 988 transactions, and (iii) section 988 transactions of a section 987 QBU are treated as marked items. Alternatively, comments requested that (if the default rules of the 2016 proposed regulations are retained) taxpayers should be permitted to elect this modified treatment.

According to the comments, the recommended modifications would achieve greater consistency with financial accounting standards and would ease the compliance burden on taxpayers. One comment stated that such an approach would also be more consistent with the statutory requirement to determine a section 987 QBU's taxable income or loss in the QBU's functional currency under sections 985 and 987. Comments noted that the opportunity for selective recognition of losses is limited to the extent the taxpayer makes a current rate election (because section 987 losses will be subject to suspension) or an annual recognition election (because section 987 gain or loss is recognized annually without regard to whether a remittance is made). One comment asserted that, even if neither of these elections is in effect, it is difficult to selectively recognize material section 987 losses attributable to section 988 transactions because the remittance proportion under §1.987-5 is determined with respect to all the assets of the section 987 QBU.

Other comments recommended providing an election under which taxpayers could recognize section 988 gain or loss with respect to all section 988 transactions of a section 987 QBU on a mark-to-market basis (effectively expanding the special rule for qualified short-term section 988 transactions to cover all section 988 transactions of a QBU). For example, one comment requested mark-to-market timing for section 988 transactions of a section 987 QBU that is subject to an annual recognition election. According to this comment, because mark-to-market timing would apply to both section 988 and section 987 gains and losses on a current basis, the potential for abuse or selective loss recognition would be limited. Another comment requested that the definition of a qualified short-term section 988 transaction under proposed §1.987-3(b)(4)(iii)(B) be expanded to include long-term transactions that have been properly identified as a hedge for U.S. tax purposes.

Finally, a comment recommended that, if the rules of the 2016 proposed regulations relating to section 988 transactions are retained in the final regulations, the applicability date of the final regulations should be deferred until taxable years beginning after December 31, 2026, so that taxpayers have adequate time to update their internal accounting systems.

C. *Treatment of Section 988 Transactions Under the Final Regulations*

1. Section 988 mark-to-market election

The final regulations provide that a taxpayer may elect to recognize section 988 gain or loss with respect to section 988 transactions of a section 987 QBU under a mark-to-market method of accounting (a "section 988 mark-to-market election"). *See* §1.987-3(b)(4)(ii). This election is expected to result in consistent treatment of section 988 transactions for tax and financial reporting purposes and to reduce the potential for selective recognition of losses relating to these transactions, as indicated by the comments. The section 988 mark-to-market election is subject to the same timing and consistency requirements as a current rate election or an annual recognition election. *See* §1.987-1(g).

The section 988 mark-to-market election does not apply to a section 988 transaction that is contributed to a section 987 QBU with a built-in loss if the section 988 transaction was not subject to a mark-to-market method of accounting in the hands of the transferor. *See* §1.987-3(b)(4)(ii)(B). This rule is intended to prevent taxpayers from accelerating the recognition of section 988 loss by contributing a section 988 transaction with a built-in loss to a section 987 QBU that is subject to the section 988 mark-to-market election.

2. Treatment of section 988 transactions of a section 987 QBU under the final regulations

The final regulations provide new rules for applying section 988 with respect to nonfunctional currency transactions of a section 987 QBU. In response to the comments summarized in part IV.B of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that a different framework is appropriate in order to reduce the compliance burden and complexity of the section 987 regulations.

Under the final regulations, whether an asset or liability of a section 987 QBU is a section 988 transaction is determined by reference to the functional currency of the section 987 QBU (instead of the owner's functional currency). *See* §1.987-3(b)(4)(i). The final regulations further provide that section 988 gain or loss with respect to section 988 transactions of a section 987 QBU (including transactions denominated in the owner's functional currency) is determined in the functional currency of the section 987 QBU, and section 988 transactions are treated as marked items. *See* §§1.987-1(d)(1)(iii) and 1.987-3(b)(4)(i). The final regulations do not provide an exception for specified owner functional currency transactions; thus, such transactions are treated as section 988 transactions of the section 987 QBU.

However, the final regulations provide an anti-abuse rule to prevent taxpayers from entering into section 988 transactions through an eligible QBU for the purpose of generating offsetting amounts of gain and loss that can selectively be recognized or deferred. Under §1.987-2(b)(3)(iv), section 988 transactions will not be treated as attributable to an eligible QBU if they are entered into (or reflected on the eligible QBU's books and records) with a principal purpose of generating offsetting amounts of section 988 gain and section 987 loss or offsetting amounts of section 988 loss and section 987 gain. Section 988 transactions also are subject to the general anti-avoidance rules of §1.987-2(b)(3)(i) through (iii).

V. Comments and Changes to Proposed §1.987-4: Determination of Net Unrecognized Section 987 Gain or Loss of a Section 987 QBU

Proposed §1.987-4 provides rules for computing net unrecognized section 987 gain or loss with respect to a section 987 QBU. In particular, proposed §1.987-4(d) provides a ten-step formula for computing unrecognized section 987 gain or loss for the current taxable year. The first step of this formula is to compute the change in owner functional currency net value ("OFCNV") for the taxable year. Proposed §1.987-4(d)(1). The other steps make adjustments for changes to OFCNV that are not attributable to changes in the exchange rate. Steps 2 through 5 relate to transfers of assets and liabilities between a section 987 QBU and its owner, and steps 6 through 9 relate to income or loss of the section 987 QBU. Proposed §1.987-4(d)(2) through (9). Step 10 is a residual adjustment for any increase or decrease to the section 987 QBU's balance sheet that is not otherwise accounted for. Proposed §1.987-4(d)(10). If a current rate election is in effect, taxpayers are required to apply only steps 1 through 5 and step 10.

Under proposed §1.987-4(e), OFCNV is determined by preparing a tax basis balance sheet reflecting the section 987 QBU's assets and liabilities. The basis of each asset and the amount of each liability is then translated into the owner's functional currency at the appropriate exchange rate. Under the default rules, marked items are translated at the year-end spot rate, while historic items are translated at the applicable historic rate. However, taxpayers that make a current rate election under §1.987-1(d)(2) translate all items on the year-end balance sheet at the year-end spot rate.

A. *Mechanics for Calculating Unrecognized Section 987 Gain or Loss for the Current Taxable Year*

1. Earnings and capital method

The preamble to the 2023 proposed regulations notes that, under a current rate election, the total amount of section 987 gain or loss recognized by an owner with respect to a section 987 QBU would be similar to the amount computed under the earnings and capital method, which was described in proposed regulations published in the **Federal Register** in 1991 (56 FR 48457, September 25, 1991) (the "1991 proposed regulations"). 88 FR 78138 through 78139. Under the earnings and capital method, the owner of a section 987 QBU computes section 987 gain or loss by maintaining an equity pool in the QBU's functional currency and a basis pool in the owner's functional currency. The equity and basis pools are increased by income of the section 987 QBU and contributions from the owner, and they are decreased by losses of the section 987 QBU and distributions from the section 987 QBU to the owner. The preamble to the 1991 proposed regulations explains that the equity pool generally represents the amount of branch equity (adjusted basis of assets net of liabilities), and the basis pool represents the owner's basis in branch equity. 56 FR 48458.

Comments requested that the final regulations include an election to apply the earnings and capital method of the 1991 proposed regulations in lieu of the current rate election. These comments indicated that, even if a current rate election is in effect, proposed §1.987-4 imposes a heightened compliance burden (as compared to the earnings and capital method) because it requires taxpayers to prepare tax basis balance sheets for each of their section 987 QBUs on an annual basis. In addition, the comments asserted that taxpayers are already familiar with the earnings and capital method and would be less likely to make errors in applying that method because taxpayers track book-to-tax adjustments in computing taxable income but do not make book-to-tax adjustments to their balance sheets. One comment recommended allowing taxpayers to use the earnings and capital method only if a current rate election and an annual recognition election are both in effect.

The final regulations do not permit taxpayers to use the earnings and capital method. As explained in the preamble to the 2023 proposed regulations, such an election would allow different taxpayers to apply section 987 using fundamentally different methodologies, which would increase the overall complexity of the section 987 regulations and make them more difficult to administer. 88 FR 78138. For example, it would be difficult for taxpayers to transition from one method to another in an administrable way. Moreover, under the earnings and capital method, the amount of section 987 gain or loss recognized is determined based on the percentage of a section 987 QBU's net equity remitted (rather than the percentage of gross assets remitted, as required under §1.987-5), which can inappropriately accelerate the recognition of section 987 gain or loss. If a section 987 QBU has negative net equity, section 987 gain or loss cannot be recognized under the earnings and capital method until the section 987 QBU terminates, which is inconsistent with the statutory requirement to recognize currency gain or loss on transfers of property from the section 987 QBU.

However, the final regulations modify the existing framework of §1.987-4 to allow taxpayers that make a current rate election to use certain elements of the earnings and capital method in lieu of preparing a tax basis balance sheet.[2] These modifications are expected to minimize the compliance burden of transitioning from the 1991 proposed regulations to the final regulations. Under the final regulations, if a current rate election is in effect, OFCNV is computed by determining the aggregate basis of the QBU's assets, net of the QBU's liabilities, in the functional currency of the section 987 QBU ("QBU net value") and translating the QBU net value into the owner's functional currency at the year-end spot rate. *See* §1.987-4(e)(2)(i) and (ii). The final regulations provide that QBU net value can be computed without a tax basis balance sheet using the formula provided in §1.987-4(e)(2)(iii).

The formula provided in §1.987-4(e)(2)(iii) is modeled on the formula used to track the equity pool under the 1991 proposed regulations, with certain modifications. Under this formula, the QBU net value on the last day of the taxable year is equal to the QBU net value at the end of the preceding taxable year, adjusted by transfers of assets and liabilities between the section 987 QBU and its owner and by income or loss of the section 987 QBU (each determined in the section 987 QBU's functional currency). If a taxpayer determines QBU net value under §1.987-4(e)(2)(iii), the taxpayer must retain the information used to determine QBU net value for each taxable year in lieu of retaining adjusted balance sheets. *See* §1.987-9(b)(2).

2. Cumulative translation adjustment

Comments requested that taxpayers be permitted to use the cumulative translation adjustment ("CTA") determined under U.S. generally accepted accounting principles ("U.S. GAAP") to compute their unrecognized section 987 gain or loss. Alternatively, some comments recommended that taxpayers should be allowed to use the CTA for this purpose only with respect to small QBUs and subject to certain tax adjustments. One comment suggested that section 987 gain or loss with respect to small QBUs should be recognized when the CTA is included in income from continuing operations under U.S. GAAP.

The final regulations do not permit taxpayers to use the CTA to determine their net unrecognized section 987 gain or loss. As explained in the preamble to the 2023 proposed regulations, section 987(3) requires currency gain or loss to be recognized at the time of a remittance, rather than when the CTA is included in income for U.S. GAAP purposes. 88 FR 78141. Moreover, the Treasury Department and the IRS have determined that significant differences may arise between the computation of the CTA for financial accounting purposes and the determination of unrecognized section 987 gain or loss under §1.987-4(d). For example, the CTA is unlikely to reflect the correct amount of currency gain or loss for tax purposes because of book-to-tax differences in the basis of assets or because certain items are disregarded for tax purposes but regarded for financial accounting purposes. If the comment's recommended approach were adopted, complex rules would be needed to adjust the CTA amount in order to derive the correct amount to be recognized for tax purposes.

3. Simplified accounting for disregarded transactions

A comment recommended that taxpayers that make a current rate elec-

[2] Taxpayers would still need to track the gross assets of a section 987 QBU for other purposes, including the denominator of the remittance proportion under §1.987-5.

tion should be permitted to determine unrecognized section 987 gain or loss for the taxable year by applying only two steps: step 1 (determining the change in OFCNV) and step 10 (reducing the amount determined in step 1 by the change in QBU net value, translated into the owner's functional currency at the yearly average exchange rate). The recommended rule would have the effect of accounting for all transfers between the owner and the section 987 QBU (which would otherwise be accounted for under steps 2 through 5) as part of step 10; consequently, the net amount of all transfers would be translated at the yearly average exchange rate. The comment posited that this approach would simplify the computations for taxpayers with a high volume of disregarded intercompany transactions.

The final regulations retain the requirement to apply steps 2 through 5 when a current rate election is in effect. Under these steps, transfers of marked assets and liabilities between a section 987 QBU and its owner generally are translated at the spot rate applicable on the date of transfer. Because the applicable spot rate may differ significantly from the yearly average exchange rate, it would not be appropriate to account for all transfers between a section 987 QBU and its owner by translating them at the yearly average exchange rate under step 10. The Treasury Department and the IRS continue to study possible simplifications of §1.987-4 relating to disregarded transactions between a section 987 QBU and its owner, including whether, in certain circumstances, unrecognized section 987 gain or loss for a taxable year could be computed using only steps 1 and 10. *See* §1.987-2(f) of the 2024 proposed regulations for proposed rules containing an election under which certain disregarded transactions between a section 987 QBU and its owner would not be taken into account in computing unrecognized section 987 gain or loss.

B. *Hedging Transactions*

1. Comment on matching source and character of section 988 gain or loss from a hedging transaction with the source and character of section 987 gain or loss

A comment recommended adoption of a hedging rule under which a taxpayer that hedges exchange rate risk with respect to its net investment in a section 987 QBU could match the source and character of the section 988 gain or loss arising from the hedging transaction with that of the section 987 gain or loss attributable to the hedged section 987 QBU. Alternatively, the comment suggested that the hedging transaction could be integrated with the section 987 QBU, such that section 988 gain or loss with respect to the hedging transaction would directly offset the section 987 QBU's unrecognized section 987 gain or loss. The comment asserted that implementing either of these recommended rules would mitigate the potential for adverse consequences (or windfalls) under section 987 when the owner's foreign currency exposure is economically hedged. The comment noted that these rules would be particularly beneficial for taxpayers that make a current rate election and an annual recognition election (and thus recognize section 987 gain or loss whether or not there is a remittance).

2. Treatment of section 987 hedging transactions under the final regulations

The Treasury Department and the IRS agree with the comment that it would be appropriate to permit symmetrical treatment of currency gain or loss with respect to a net investment hedge and the hedged section 987 QBU.[3] Accordingly, §1.987-14 of the final regulations provides new rules that apply to certain identified hedging transactions entered into by the owner of a section 987 QBU ("section 987 hedging transactions").

Under §1.987-14(d), section 988 gain or loss that would otherwise be recognized on a section 987 hedging transaction ("hedging gain or loss") is instead taken into account in adjusting the owner's unrecognized section 987 gain or loss for the taxable year (as determined under §1.987-4(d)). For example, if the owner has unrecognized section 987 gain for the taxable year under §1.987-4(d), the owner's hedging loss reduces the unrecognized section 987 gain. However, hedging loss cannot reduce unrecognized section 987 gain for the taxable year below zero, and hedging gain cannot reduce unrecognized section 987 loss for the taxable year below zero. This limitation ensures that hedging gain or loss in excess of the currency exposure generated by the section 987 QBU for the taxable year is not taken into account under section 987.

3. Requirements to qualify as a section 987 hedging transaction

A section 987 hedging transaction generally is defined as a financial instrument (a "hedge") entered into by the owner of a section 987 QBU for the purpose of managing exchange rate risk with respect to the owner's net investment in the section 987 QBU as part of the normal course of the owner's trade or business. The hedge may be entered into with an unrelated counterparty or with a related person. For example, a CFC that owns a section 987 QBU may enter into a hedge with its U.S. parent, which has entered into a similar, offsetting, transaction with a third party.

Several requirements must be met in order for a hedge to qualify as a section 987 hedging transaction. First, the hedge must be identified as a section 987 hedging transaction with respect to the hedged QBU on or before the day the owner enters into the hedge. *See* §1.987-14(b)(2)(i) and (c). A hedge cannot be identified as a section 987 hedging transaction with respect to more than one section 987 QBU. However, if a grouping election is in effect under §1.987-1(b)(3)(ii), all section 987 QBUs that have the same functional currency will be treated as a single section 987 QBU. The final regulations also provide a special rule for cases in

[3] The Treasury Department and the IRS previously published proposed regulations in the Federal Register on December 19, 2017 (82 FR 60135), which contained proposed rules relating to the treatment of a net investment hedge for purposes of the business needs exception to the definition of foreign personal holding company income under section 954(c)(1)(D) and §1.954-2(g)(2)(ii). Those proposed regulations would apply only for purposes of the business needs exception and do not address the potential for mismatches in other contexts.

which a taxpayer fails to properly identify a hedge due to inadvertent error. *See* §1.987-14(c)(2).

Second, a current rate election must be in effect for the taxable year. *See* §1.987-14(b)(2)(ii). In the absence of a current rate election, gain or loss on a net investment hedge is unlikely to be comparable in amount to the owner's unrecognized section 987 gain or loss, and thus the rules of §1.987-14 would not serve their intended function.

Third, the owner (and any members of the same controlled group that are parties to the hedge) must account for section 988 gain or loss with respect to the hedge under a mark-to-market method of accounting (for example, under section 1256 or in reliance on proposed §1.988-7). *See* §1.987-14(b)(2)(iii). As a result of this requirement, foreign currency gain or loss on the hedge will be taken into account in the taxable year in which the related currency gain or loss is determined under §1.987-4(d).

Fourth, under U.S. GAAP, foreign currency gain or loss on the hedge must be properly accounted for as a cumulative foreign currency translation adjustment to shareholders' equity. *See* §1.987-14(b)(2)(iv). This requirement helps to ensure that the hedge is economically related to the owner's net investment in the section 987 QBU.

Fifth, the hedge must be entered into by the owner of the section 987 QBU, and not by a section 987 QBU of the owner (that is, the hedge cannot itself be an asset attributable to a section 987 QBU). *See* §1.987-14(b)(2)(v).

Finally, an anti-abuse rule provides that a hedge does not qualify as a section 987 hedging transaction if the hedge or a related transaction is entered into with a principal purpose of converting section 987 gain or loss into section 988 gain or loss. *See* §1.987-14(b)(3). For example, a taxpayer that owns a section 987 QBU might enter into a hedging transaction with a related party without hedging the related party's resulting exchange rate risk (effectively shifting the exchange rate risk without reducing the group's overall foreign currency exposure) for the purpose of taking the related foreign currency gain or loss into account under section 988 (rather than section 987). Under the anti-abuse rule, the net investment hedge would not be treated as a section 987 hedging transaction.

4. Consolidated groups

With regard to consolidated groups (as defined in §1.1502-1(h)), §1.987-14(b)(2)(v) of the final regulations requires that the same corporation be the owner of the QBU and enter into the section 987 hedging transaction with respect to that QBU (similar requirements apply when a member of a consolidated group engages in a section 988(d) hedging transaction under §1.988-5(a)(5)(v) or (b)(2)(i)(F)). The Treasury Department and the IRS continue to study whether it would be possible to treat consolidated group members as a single corporation for purposes of §1.987-14 and the section 988(d) hedging transaction rules without inappropriately shifting income among members of the group. *See also* TD 8400, 57 FR 9172, 9176 (soliciting comments on whether to permit the rules of §1.988-5 to be applied by treating consolidated group members as a single corporation).

VI. Comments and Changes to Proposed §1.987-5: Recognition of Section 987 Gain or Loss

Proposed §1.987-5 provides rules for determining the amount of section 987 gain or loss recognized by the owner of a section 987 QBU.

Under proposed §1.987-5(a), when a section 987 QBU makes a remittance, the owner recognizes section 987 gain or loss. In general, the amount recognized equals the section 987 QBU's net unrecognized section 987 gain or loss multiplied by the owner's remittance proportion. The remittance proportion is determined in the owner's functional currency; it is equal to the amount of the remittance for the taxable year, divided by the aggregate basis of the section 987 QBU's gross assets reflected on its year-end balance sheet (without reduction for the remittance). Proposed §1.987-5(b). For a taxable year, the amount of a remittance equals the excess of (i) the aggregate of all amounts transferred from the section 987 QBU to the owner during the taxable year; over (ii) the aggregate of all amounts transferred from the owner to the section 987 QBU during the taxable year (each determined in the owner's functional currency). Proposed §1.987-5(c).

A comment noted that, for taxpayers with a high volume of disregarded intercompany transactions, it can be difficult to track the amount of each transfer between the section 987 QBU and its owner and to translate the transfer into the owner's functional currency at the appropriate exchange rate. The comment recommended that the amount of a remittance should be deemed to be equal to the change in the QBU's net value (if negative) for the taxable year.

Despite compliance and administrative burdens that may result in certain cases from tracking disregarded transfers for purposes of determining the amount of a remittance, it would not be appropriate to determine the remittance amount based solely on the negative change in net value of a section 987 QBU. Such an approach would not properly account for distributions out of a section 987 QBU's current year earnings. For example, if a section 987 QBU distributed an amount exactly equal to its current year earnings, there would be no change in the QBU's net value (and thus, no remittance) under the comment's recommended approach, even if the QBU made a substantial distribution. Section 987(3) and its legislative history indicate that Congress intended for gain or loss to be recognized on any remittance from a section 987 QBU, without regard to whether the remittance is sourced from current year earnings, prior year earnings, or capital contributions.

Nonetheless, the final regulations provide two modifications that are intended to reduce the burden of tracking disregarded transfers for purposes of §1.987-5 while preserving consistency with the text and purpose of section 987. First, the final regulations provide an alternative formula for computing the annual remittance that is based on the comment's recommended approach (and does not require tracking of individual transfers) but contains an adjustment to account for remittances out of current-year income. Under this formula, the remittance amount is equal to the negative change in net value of the section 987 QBU (determined in the QBU's functional currency), adjusted for income and loss of the section 987 QBU. *See* §1.987-5(c)(2). Mathematically, this formula will produce an amount that is equal to the aggregate net transfer from the section 987 QBU to its owner for the taxable year.

Second, §1.987-5(b) and (c) provide that the numerator and denominator of the remittance proportion (that is, the amount of the remittance and the section 987 QBU's gross assets) are determined in the section 987 QBU's functional currency, rather than the owner's functional currency. As a result, it is not necessary to separately translate each transfer for purposes of determining the annual remittance.

VII. Comments and Changes to Proposed §1.987-6: Character and Source of Section 987 Gain or Loss

A. Determining the Character and Source of Section 987 Gain or Loss.

1. In general

Under proposed §1.987-6, section 987 gain or loss is assigned to the statutory and residual groupings in two steps: an initial assignment under proposed §1.987-6(b)(2)(i), followed by a reassignment described in proposed §1.987-6(b)(2)(ii). The initial assignment is made using the asset method under §§1.861-9(g) and 1.861-9T(g). It is made after the application of the income attribution rules of §1.904-4(f)(2)(vi) or §1.951A-2(c)(7), but before expenses are allocated and apportioned to gross income and before the application of provisions that require a net income computation. Section 987 gain or loss may be reassigned if required after the application of provisions that require a net income computation. For example, if an item of section 987 gain is initially assigned to tentative tested income, it will be reassigned to tested income or residual income depending on whether the taxpayer has made the GILTI high-tax exclusion election and, if so, whether the item (described in proposed §1.987-6(b)(2)(iii)) is subject to a high rate of tax.

2. Asset method

The asset method under §§1.861-9 and 1.861-9T is intended to serve as an administrable proxy for a section 987 QBU's historical earnings, in line with the statutory requirement of section 987(3)(B) (which provides that section 987 gain or loss is sourced by reference to the source of the income giving rise to post-1986 accumulated earnings). As explained in the preamble to the 2016 final regulations, it would be complex and burdensome to source and characterize section 987 gain or loss with direct reference to post-1986 accumulated earnings, and the gross assets of a section 987 QBU provide a reasonable proxy for historical earnings that is relatively easy to administer. 81 FR 88814.

A comment recommended that CFCs which apportion interest expense using the modified gross income method be permitted to use the same method to determine the character and source of section 987 gain or loss (rather than using the asset method under §§1.861-9(g) and 1.861-9T(g)). According to the comment, the asset method may not accurately reflect the income earned by the CFC for the taxable year, and section 987 losses often could be allocated to a subpart F income group in excess of the income recognized in that group for the taxable year. The comment noted that the use of the modified gross income method would be more administrable and would more readily allow section 987 losses to be used against gross income recognized in the current year, since the source and character of the section 987 loss would be determined by reference to the section 987 QBU's gross income for the current year.

The final regulations do not permit CFCs to use the modified gross income method to source and characterize section 987 gain or loss because the source and character of a section 987 QBU's gross income may vary significantly from year to year, including by reason of extraordinary events or as a result of tax planning. Accordingly, the gross income earned in a single year is not a sufficiently reliable proxy for historical earnings for purposes of section 987(3)(B).

3. Timing of source and character determination

The 2023 proposed regulations provide that the initial assignment of section 987 gain or loss would generally be made in the taxable year in which the section 987 gain or loss is treated as recognized, deferred, or suspended. Proposed §1.987-6(b)(1).

Comments requested that the character and source of suspended section 987 loss and deferred section 987 gain or loss be determined in the year in which it is recognized, rather than in the year in which it becomes suspended or deferred. The comments noted that the proposed rules would require extensive tracking of the source and character of section 987 gain or loss in multiple categories over multiple years. Comments also posited that the potential for distortion due to changes in the basis of a QBU's assets or shifts in the character of its income would be present whether the section 987 gain or loss is characterized in the taxable year in which it becomes suspended or deferred or in the taxable year in which it is recognized.

The final regulations retain the rules of proposed §1.987-6(b)(1)(ii) and (iii), under which suspended section 987 loss and deferred section 987 gain or loss are characterized in the year of suspension and deferral, respectively, for several reasons.

First, making an initial assignment in the taxable year of deferral or suspension provides parity in the timing of the characterization of gains and losses (that is, both gains and losses are characterized in the year of a remittance or termination).

Second, this rule is expected to produce source and character determinations that more closely align with the historical income of the section 987 QBU during the period in which the relevant section 987 gain or loss arose. Making an initial assignment in the taxable year of deferral or suspension means that source and character are determined by reference to the assets of the section 987 QBU contemporaneously with the remittance or termination, while the affected assets are still taken into account for purposes of applying the asset method under §§1.861-9 and 1.861-9T. By contrast, waiting until the year of recognition would require deferred section 987 gain or loss and (in some cases) suspended section 987 loss to be characterized after the section 987 QBU has been terminated and its assets have been transferred to a related party, which could result in substantial distortions.

Third, the timing rule of §1.987-6(b)(1)(ii) is needed to facilitate the separate application of the loss-to-the-extent-of-gain rule under §1.987-11(e) to section 987 gain or loss in each recognition grouping. As explained in part X.B.3 of this Summary of Comments and Explanation of Revisions, in order to prevent taxpayers from avoiding the loss limitation through the selective recognition of section 987 gains that are subject to a low rate of tax (or are not subject to U.S. tax), §1.987-11(e) provides that suspended section 987 loss in a recognition grouping is not recognized until section 987 gain in the same recognition grouping is recognized. For this rule to achieve its policy objective, suspended section 987 loss must be sourced and characterized before determining whether it can be recognized under §1.987-11(e). If suspended section 987 loss were not characterized until the year of recognition, there would be no administrable way to identify suspended section 987 loss in the relevant recognition grouping for purposes of §1.987-11(e) because the source and character of the suspended section 987 loss would not yet have been determined.

Finally, in response to comments regarding compliance burden generally, the final regulations include a number of new rules intended to simplify the tracking of suspended section 987 loss or deferred section 987 gain or loss. For instance, the new de minimis rule (described in part X.A.1 of this Summary of Comments and Explanation of Revisions) is expected to reduce the burden of tracking suspended section 987 loss because section 987 loss will be suspended only if it exceeds the de minimis threshold (the lesser of $3 million or two percent of gross income). *See* §1.987-11(c)(2). In addition, taxpayers that make the annual recognition election generally would not be subject to the deferral and loss suspension rules (and thus would not need to track deferred section 987 gain or loss or suspended section 987 loss). The lookback rule (described in part X.B.1 of this Summary of Comments and Explanation of Revisions) will permit suspended section 987 loss to be recognized in the year of a remittance to the extent of gain recognized during the lookback period, which will limit the amount of suspended section 987 loss carried forward to future years. Additionally, the new rules relating to the characterization of section 987 gain or loss for purposes of subpart F (described in part VII.B of this Summary of Comments and Explanation of Revisions) provide taxpayers more flexibility in characterizing their section 987 gain and loss relating to subpart F income groups, including an election that will limit the number of subpart F income groups for which tracking is required.

B. *Characterization of Section 987 Gain or Loss for Purposes of Subpart F*

1. In general

Under proposed §1.987-6(b)(2)(i)(C), section 987 gain or loss assigned to a subpart F income group is treated as foreign currency gain or loss attributable to section 988 transactions not directly related to the business needs of the CFC for purposes of section 954(c)(1)(D).

Some comments recommended that, for subpart F purposes, section 987 gain or loss should instead be assigned to the same subpart F income groups as the income generated by the section 987 QBU's assets. The comments noted that the recommended rule would better align the characterization of section 987 gain or loss with the underlying assets and income of the section 987 QBU and would permit broader utilization of section 987 loss because the loss could be netted against income in the same subpart F income groups. One comment asserted that the recommended rule would be more consistent with section 987(3)(B), which requires section 987 gain or loss to be sourced by reference to the source of the income giving rise to post-1986 accumulated earnings.

Other comments stated that section 987 gain or loss should not be treated as foreign personal holding company income described in section 954(c)(1)(D) because section 954(c)(1)(D) refers to foreign currency gains or losses under section 988 and makes no reference to gain or loss recognized under section 987(3). One comment questioned whether section 987 gain or loss should be assigned to any subpart F income group because section 954 does not explicitly identify section 987 gain as a category of subpart F income.

Another comment requested that, if proposed §1.987-6(b)(2)(i)(C) is retained for taxpayers applying the default rules, a different rule should be provided for taxpayers that make a current rate election (under which all assets and liabilities of a section 987 QBU give rise to currency gain or loss). A comment also recommended that, if proposed §1.987-6(b)(2)(i)(C) is retained, the final regulations should clarify that, for taxpayers predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, section 987 gain or loss that is assigned to a subpart F income group is treated as financial services income within the meaning of section 904(d)(2)(C).

Other comments requested that, if section 987 gain or loss is treated as gain or loss from section 988 transactions not directly related to the business needs of the CFC, taxpayers should be permitted to use the elections available under §1.954-2(g)(3) (characterizing section 988 gain or loss that arises from a specific category of subpart F income as gain or loss in that category) and §1.954-2(g)(4) (treating all section 988 gain or loss as foreign personal holding company income). One comment recommended that, for purposes of the election under §1.954-2(g)(3), section 987 gain or loss should be allocated to categories of foreign base company income on a proportionate basis without requiring direct tracing of section 987 gain or loss to specific transactions or assets.

The final regulations retain the approach in the 2023 proposed regulations and treat section 987 gain or loss as subpart F income to the extent that the assets of the section 987 QBU generate subpart F income under the asset method of §§1.861-9(g) and 1.861-9T(g). *See* §1.987-6(b)(2)(i)(A). However, the Treasury Department and the IRS agree with the comments that assigning section 987 gain or loss to the same subpart F income groups as the income generated by the section 987 QBU's assets is most consistent with the principles of section 987(3)(B) and is therefore the most appropriate exercise of authority under sections 987(3) and 989(c). Accordingly, under the final regulations, the characterization of section 987 gain or loss is determined under the general rule of §1.987-6 using the asset method of §§1.861-9(g) and 1.861-9T(g), including by assigning section 987 gain or loss to subpart F income groups. Thus, for example, if a QBU's assets generate foreign base company sales income, the section 987 gain or loss will be characterized as foreign base company sales income.

The Treasury Department and the IRS do not agree with the suggestion that section 987 gain or loss cannot give rise to subpart F income merely because section 954 does not explicitly identify section 987 gain as a separate category of subpart F income. Section 987(3) requires "proper adjustments (as prescribed by the Secretary)" to taxable income of the owner of a section 987 QBU. Further regulatory authority is provided in section 989(c). The adjustments required under section 987(3) include sourcing gain or loss recognized on a remittance by reference to the QBU's historical earnings under section 987(3)(B). This sourcing rule serves to characterize the adjustments to income under section 987(3) in the same way as the QBU's underlying income. Similarly, when a QBU's income is taken into account in determining the owner's subpart F income, proper adjustments must necessarily include adjustments to that type of income. Therefore, section 987 gain or loss must be characterized as foreign personal holding company income or other types of income described in section 952(a), in appropriate circumstances, to effectuate the intent of Congress reflected in the broader statutory scheme.

2. Election to treat certain section 987 gain or loss as foreign currency gain or loss attributable to section 988 transactions

In the case of section 987 gain or loss that would otherwise be characterized as passive foreign personal holding company income, the final regulations provide an election to treat the section 987 gain or loss as foreign currency gain or loss of the CFC-owner that is attributable to section 988 transactions not directly related to the business needs of the CFC (the "section 988 characterization election"). *See* §1.987-6(b)(2)(i)(C)(*1*). This election is intended to benefit taxpayers because it would generally allow section 987 gains and losses assigned to passive foreign personal holding company income groups, which would otherwise be treated as separate items (or as allocable to separate items) of passive foreign personal holding company income under the rules in §1.954-1(c)(1)(iii)(B), to be treated as part of (or allocable to) a single item of income. This would generally facilitate some netting of the CFC-owner's section 987 gains and losses (because they would be assigned to the same item of income) and would also generally permit a CFC-owner to net its foreign currency gains and losses from section 988 transactions with the section 987 gain or loss from its QBUs (to the extent both comprise passive foreign personal holding company income). Similarly, the section 988 characterization election should, in many cases, reduce the number of recognition groupings under §1.987-11(f), thereby simplifying the application of the loss-to-the-extent-of-gain rule and minimizing the tracking burden with respect to any suspended losses.

Section 987 gain or loss subject to the section 988 characterization election is not eligible for the business needs exception under §1.954-2(g)(2) because this election applies only to section 987 gain or loss that would otherwise be characterized by reference to assets that give rise to passive foreign personal holding company income. The business needs exception is available only for foreign currency gain or loss arising from a transaction or property that does not give rise to subpart F income (which includes foreign personal holding company income). *See* §1.954-1(g)(2)(ii)(B)(*1*)(*ii*).

Similarly, section 987 gain or loss subject to the section 988 characterization election is not eligible for the election in §1.954-2(g)(3) (election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category). The §1.954-2(g)(3) election applies only to gain or loss that is related to income categories described in the foreign base company income groups of §1.954-1(c)(1)(iii)(A)(*1*) or (*2*) or the other subpart F income categories described in section 952(a); it does not apply to gain or loss related to passive foreign personal holding company income.[4] By contrast, the section 988 characterization election applies only to section 987 gain or loss that would otherwise be characterized by reference to assets that give rise to passive foreign personal holding company income. Thus, the two elections are mutually exclusive by their terms.

Finally, section 987 gain or loss subject to the section 988 characterization election is not eligible for the election in §1.954-2(g)(4) (election to treat all foreign currency gains or losses as foreign personal holding company income). Extending the §1.954-2(g)(4) election to section 987 gain or loss could permit inappropriate use of section 987 losses and would be inconsistent with the limited purpose of the section 988 characterization election. Therefore, if an election is in effect under §1.954-2(g)(3) or (4), the foreign currency gain or loss to which the election applies is simply determined without regard to the section 987 gain or loss treated as foreign currency gain or loss attributable to a section 988 transaction by reason of the section 988 characterization election.

C. *GILTI High-Tax Exclusion*

Under the 2023 proposed regulations, for purposes of applying the high-tax exclusion in §1.951A-2(c)(7) (the "GILTI HTE"), all section 987 gain and loss in a tentative tested income group that is recognized by a CFC in a taxable year is treated as a single tentative tested income item that is treated as recognized by a tested unit separate from the CFC's other tested units. Proposed §1.987-6(b)(2)(iii). As a result, section 987 gain or loss is not taken into account in applying the GILTI HTE with respect to the CFC's other items of tentative tested income. Instead, the GILTI HTE is applied separately to section 987 gain and loss and, as a result, section 987 gain or loss generally will not be eligible for the GILTI HTE unless the CFC is subject to foreign tax on currency gain recognized with respect to its interest in the QBU under the applicable foreign tax rules. *See* proposed §1.987-6(b)(3).

[4] While §1.954-1(c)(1)(iii)(A)(*1*) includes categories of foreign personal holding company income, it expressly excludes passive foreign personal holding company income, which is described in §1.954-1(c)(1)(iii)(B). Therefore, the two elections apply to mutually exclusive income groups.

Some comments noted that these rules would preclude the application of the GILTI HTE with respect to section 987 gain of a CFC even if the CFC's section 987 QBUs are operating in jurisdictions subject to a high foreign tax rate. Another comment noted that the proposed rules would treat section 987 gain or loss differently from currency gain or loss recognized under section 988 (for example, section 988 gain or loss on a net investment hedge with respect to the section 987 QBU) and would make it difficult to project a taxpayer's effective tax rate due to the unpredictability of exchange rate fluctuations. This comment recommended that proposed §1.987-6(b)(2)(iii) be modified to provide that (i) section 987 gain and loss is taken into account in determining the effective tax rate under §1.951A-2(c)(7)(vi) and (ii) section 987 gain or loss associated with highly taxed tested units is excluded from the computation of tested income.

The final regulations retain the rule that section 987 gain or loss is treated as a single tentative tested income item that is separate from the CFC's other tested units. *See* §1.987-6(b)(2)(iii). Although section 987 gain or loss is characterized by reference to the historical earnings of the section 987 QBU, which may correspond to one or more tested units, it is not equivalent to current year income or loss attributable to a tested unit. Section 987 gain or loss is not properly attributable to the tested unit that corresponds to the section 987 QBU or to the CFC tested unit, because in most cases neither the tested unit's country of residence nor the CFC's country of residence will take the section 987 gain or loss into account in determining foreign gross income. Therefore, attributing section 987 gain or loss to either tested unit would tend to be distortive and generally would not further the goals of the high-tax exclusion.[5]

In addition, treating section 987 gain or loss as a single item of tentative tested income, as if it were attributable to a separate tested unit (distinct from the section 987 QBU), is consistent with the determination that a branch comprises a separate tested unit, even if it is not a tax resident of the foreign country in which it is located, if the income of the branch is subject to an exclusion, exemption, or other similar relief (such as a preferential rate) in the CFC's country of tax residence. *See* §1.951A-2(c)(7)(iv)(A)(*3*). Section 987 gain or loss is currency gain or loss of the owner of the QBU, and these gains and losses are generally not subjected to residency-based taxation in either the country of the QBU or the country in which the CFC is a resident. Therefore, the section 987 gains and losses of the CFC are functionally equivalent to gain or loss of a branch that is not a tax resident in any country and whose income is not subject to residency-based taxation in the CFC's country of tax residence.

Accordingly, it is appropriate to test the effective rate of foreign tax on section 987 gains and losses as a separate item of tentative tested income. The alternative approach recommended by a comment (which would incorporate section 987 gain or loss in the tested units that correspond to the section 987 QBU) would distort the effective tax rate computation with respect to a CFC's other income because section 987 gain or loss typically is not subject to foreign tax. These distortions could be favorable or unfavorable to taxpayers, depending on the circumstances. Moreover, the comment's recommended approach would complicate the ordering rules and mechanics needed to apply the loss-to-the-extent-of-gain rule of §1.987-11(e) with respect to section 987 gain or loss assigned to a tested income group, which would increase the administrative and compliance burden of the section 987 regulations.

The approach set forth in the proposed regulations is also most consistent with the policy underlying the determination of an appropriate "item" of income for purposes of applying the high-tax exception under section 954(b)(4) as is reflected in the legislative history to that section, which directs the Treasury Department and the IRS to allow reasonable groupings of items of income that are substantially taxed at the same rate in a single country. *See* H.R. Rept. No. 99–426, at 400–01 (1985) ("Although this rule applies separately with respect to each 'item of income' received by a [CFC], the committee expects that the Secretary will provide rules permitting reasonable groupings of items of income that bear substantially equal effective rates of tax in a given country. For example, all interest income received by a [CFC] from sources within its country of incorporation may reasonably be treated as a single item of income for purposes of this rule, if such interest is subject to uniform taxing rules in that country."). The Treasury Department and the IRS have determined that section 987 gains and losses are likely to be taxed at a different rate of tax than other income generally subject to tax either in the country of the tested unit or in the country of residence of the CFC and therefore should reasonably be grouped and tested as a separate "item" of income for this purpose.

As noted in a comment, for purposes of the GILTI HTE, the final regulations treat section 987 gain or loss differently from section 988 gain or loss on a net investment hedge. However, the new hedging rule in §1.987-14 will enable taxpayers to account for the hedge as an adjustment to unrecognized section 987 gain or loss, as described in part V.B of this Summary of Comments and Explanation of Revisions.

VIII. Comments and Changes to Proposed §§1.987-7A, 1.987-7B, and 1.987-7C— Partnerships

A. *Partnership Rules Under the 2023 Proposed Regulations*

The 2023 proposed regulations (and the 2016 final regulations) generally would apply aggregate theory to partnerships wholly owned by related persons ("section 987 aggregate partnerships"). *See* proposed §1.987-7B. Under pro-

[5] While the legislative history relating to the GILTI high-tax exclusion indicates that high-taxed income does not present base erosion concerns, the policy rationale underlying that view does not extend to excluding low-taxed income from GILTI merely because it may be earned by an entity that also earns high-taxed income. *See* S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print. No. 115–20, at 371 (2017) ("The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI [regime], either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of the base erosion concerns—or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax.").

posed §1.987-1(b)(5)(ii), each partner in a section 987 aggregate partnership would be treated as an indirect owner of the partnership's eligible QBUs (and a section 987 aggregate partnership is not itself a QBU under section 989(a)). Thus, exchange gain or loss under section 987 would be measured from the perspective of the partners (rather than the partnership). The aggregate approach would serve to prevent a group of related parties from holding an eligible QBU through a partnership (rather than owning it directly) in order to change the section 987 treatment of the eligible QBU without meaningfully altering the group's economic position.

The 2023 proposed regulations would provide a different set of rules for partnerships that are not wholly owned by related partners. *See* proposed §1.987-7A. For these partnerships, the 2023 proposed regulations would apply a hybrid approach to entity theory, under which unrecognized section 987 gain or loss of the partnership's eligible QBUs for a taxable year is determined at the partnership level and then allocated to the partners for purposes of computing the pool of net unrecognized section 987 gain or loss. Any section 987 gain or loss would be recognized and taken into account at the partner level.

The preamble to the 2023 proposed regulations notes that the Treasury Department and the IRS considered whether it would be appropriate to apply a hybrid approach to all partnerships, regardless of whether the partners are related. 88 FR 78147 through 78148. The preamble explains that such an approach might reduce the complexity and compliance burden of the section 987 regulations, but that it could permit taxpayers to manipulate the application of section 987 by holding a section 987 QBU through a partnership rather than holding it directly. *Id*. at 78148.

The 2023 proposed regulations would not provide rules relating to a partner's application of section 987 with respect to a partnership that uses a different functional currency (which creates a separate layer of currency exposure). However, the preamble to the 2023 proposed regulations discusses alternative methodologies under which the partners could determine and recognize section 987 gain or loss with respect to their partnership interests. 88 FR 78148 through 78149.

B. *Partnership Rules in the Final Regulations*

1. In general

The Treasury Department and the IRS continue to study the appropriate treatment of partnerships for purposes of section 987 and, accordingly, the final regulations do not provide detailed rules concerning the determination of section 987 taxable income or loss and section 987 gain or loss in the case of a partnership. The final regulations also reserve on the treatment of a partnership as a QBU under section 989(a) and §1.989(a)-1(b)(2)(i). *See* §1.989(a)-1(b)(2)(i)(C).

Only one comment regarding partnerships was received in response to the 2023 proposed regulations. The portions of the comment that relate to partnership rules that are not included in the final regulations have not been adopted because they are outside the scope of these regulations. The Treasury Department and the IRS expect to address these issues in future guidance.

Pending future guidance, taxpayers must apply sections 987 and 989(a) with respect to partnerships using a reasonable method consistent with the statute. For example, if a domestic corporation owns an interest in a foreign partnership (which would use the euro as its functional currency if it is treated as a QBU under section 989(a)), and the partnership owns an eligible QBU that uses the Swiss franc as its functional currency, the domestic corporation may apply section 987 to the eligible QBU under an aggregate approach. Alternatively, under an entity approach, the partnership could be treated as a section 987 QBU of the domestic corporation, and the eligible QBU could be treated as a section 987 QBU of the partnership. The domestic corporation could also apply a hybrid approach under the principles of the 2023 proposed regulations. However, taxpayers will not be considered to have applied a reasonable method unless they apply the same method consistently from year to year with respect to a particular partnership or eligible QBU. Members of a controlled group that are partners in the same partnership must apply the same method with respect to a particular partnership or eligible QBU, but unrelated partners are not subject to a consistency requirement. *See* §1.987-7(b).

2. Application of the final regulations to partnerships

Although section 987 applies to partnerships, only certain parts of the final regulations apply to partnerships. *See* §1.987-7(b) and (c). In particular, the rules relating to suspended section 987 loss in §§1.987-11 and 1.987-13 apply to partnerships, and the deferral rules of §1.987-12 continue to apply to partnerships, with certain modifications. *See* §1.987-7(c)(2)(i) and (d). These rules are needed to prevent the selective recognition of losses. In addition, the final regulations provide that an annual recognition election and a section 988 mark-to-market election can be made with respect to a partnership (whether an aggregate or entity approach is applied). *See* §1.987-7(c)(2)(ii) and (iii). These elections are expected to reduce the compliance burden of applying section 987 in the partnership context.

Similarly, the rules for determining the source and character of section 987 gain or loss under §1.987-6 apply to partnerships, in order to facilitate application of the loss-to-the-extent-of-gain rule. *See* §1.987-7(c)(2)(i). A comment suggested that special rules should apply to determine the source and character of section 987 gain or loss recognized in connection with the sale or redemption of a partnership interest under the principles of §1.864(c)(8)-1. The final regulations do not adopt this approach because it would be inconsistent with section 987(3)(B) (under which section 987 gain or loss is sourced by reference to historical earnings) and could allow taxpayers to manipulate the source and character of section 987 gain or loss.

Because the section 987 regulations generally do not apply to partnerships, the general rules of the section 987 regulations must be adapted as necessary to apply §1.987-7 and the other applicable provisions to partnerships. *See* §1.987-7(c)(3). The rules must also be applied in this manner to an S corporation, which is treated the same way as a partnership for purposes of the section 987 regulations. *See* §1.987-7(f).

3. Loss suspension rule

Under the final regulations, the general loss suspension rule in §1.987-11(c)(1) does not apply to partnerships. *See* §1.987-7(d)(1)(i). Instead, section 987 loss generally will be suspended in the taxable year in which it would otherwise be recognized under the method used by the taxpayer to apply section 987 with respect to the partnership. *See* §1.987-7(d)(1)(ii). The loss suspension rule of §1.987-7(d)(1)(ii) applies to an eligible QBU that is directly owned by a partnership, regardless of whether an aggregate approach, an entity approach, or a hybrid approach is applied. *See* §1.987-7(d)(1)(ii)(A). However, if a partnership is itself treated as a section 987 QBU of its partners under an entity approach, the loss suspension rule applies only if at least 95% of the capital and profits interests in the partnership are owned by related persons. *See* §1.987-7(d)(1)(ii)(B). This limitation is intended to reduce the complexity and compliance burden of the section 987 regulations for partnerships owned by unrelated persons.

The final regulations provide several other exceptions to the loss suspension rule of §1.987-7(d)(1)(ii). First, section 987 loss with respect to an eligible QBU owned by a partnership is not suspended if section 987 is consistently applied using a method under which section 987 gain or loss does not arise with respect to historic items (for example, a method that follows the principles of §§1.987-3 through 1.987-5, under which historic items are assigned a historic rate, such that their balance sheet value does not change in response to changes in the value of the section 987 QBU's functional currency). *See* §1.987-7(d)(2)(i). Second, section 987 loss is not suspended if an annual recognition election is in effect. *See* §1.987-7(d)(2)(ii). Finally, section 987 loss is not suspended if the de minimis rule in §1.987-11(c)(2) applies (that is, if the amount of section 987 loss subject to suspension does not exceed the lesser of $3 million or two percent of gross income, as described in part X.A.1 of this Summary of Comments and Explanation of Revisions). *See* §1.987-7(d)(2)(iii). These rules generally align with the scope of the loss suspension rule in §1.987-11(c)(1).

4. Adjustments to the basis of a partner's interest in the partnership

The proposed regulations would provide that a partner's basis in a partnership is adjusted when the partner recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss attributable to the partnership. Proposed §1.987-7A(e). This rule is intended to avoid duplication of section 987 gain or loss (for example, when the partnership interest is sold). The final regulations retain this rule for taxpayers that apply section 987 using a method that results in recognition, deferral, or suspension of section 987 gain or loss at the partner level. Under §1.987-7(e), the partner's basis in its partnership interest is adjusted under the principles of section 705 as though the section 987 gain or loss was part of the partner's distributive share of partnership items. *See* §1.987-7(e).

A commenter requested clarification concerning the interaction of this basis adjustment rule with section 704(d). Section 704(d)(1) provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the basis of that partner's interest in the partnership at the end of the partnership year in which such loss occurred. Section 704(d)(2) provides for the carryover of the excess of any loss over such basis to the next taxable year. To the extent that basis is available in the next taxable year, the partner is able to take the loss into account. Relatedly, the partner will decrease the adjusted basis in its partnership interest to the extent that any loss carryover is taken into account within the taxable year. *See* section 705(a)(2).

The final regulations clarify that the principles of section 704(d) are applied as though items of section 987 loss, deferred section 987 loss, or suspended section 987 loss were part of the partner's distributive share of partnership items. *See* §1.987-7(e). The basis adjustment rule in §1.987-7(e) is intended to replicate the basis adjustments that would occur if the relevant section 987 gain or loss was taken into account as part of the partner's distributive share of partnership income or loss (including the effects of section 704(d)).

5. Other special rules for partnerships

The final regulations contain several other rules that facilitate the application of section 987 to partnerships. If a partner in a partnership is treated as the owner of a section 987 QBU directly owned by the partnership (for example, under an aggregate approach), §1.987-7(c)(3)(ii) provides a special rule that is used to determine the members of the owner's controlled group for purposes of §§1.987-12 and 1.987-13. Under this rule, any member of the partnership's controlled group is treated as a member of the partner's controlled group so long as the partner continues to be a partner in the partnership. Thus, for example, if the partnership contributes the section 987 QBU's assets to a wholly owned subsidiary of the partnership, the subsidiary will be treated as a member of the partner's controlled group and the contribution may be treated as a deferral event for purposes of §1.987-12.

When a partnership is itself treated as a QBU of a partner that is subject to section 987, and the partnership is not engaged in any trade or business (for example, a partnership that functions as a holding company), the rules of §1.987-13(b) through (d) do not apply. Those rules are designed to attribute suspended section 987 loss to a successor suspended loss QBU if the assets of a section 987 QBU continue to be used in the same trade or business by a member of the controlled group, and they trigger the recognition of suspended section 987 loss if the section 987 QBU terminates without a successor. However, when a QBU that has suspended section 987 loss is not engaged in any trade or business, the rules of §1.987-13(b) through (d) would not result in the appropriate recognition of suspended section 987 loss and could be prone to manipulation. Accordingly, the suspended section 987 loss can be recognized only under the loss-to-the-extent-of-gain rule of §1.987-11(e).

The transition rules in §1.987-10 do not apply to partnerships. Instead, the applicable rules of the section 987 regulations take effect on the transition date with respect to section 987 gain or loss determined and recognized under the taxpayer's existing method. In addition, taxpayers may not apply the fresh start transition method with respect to a partnership. As explained in the preamble to the 2023 proposed regulations, the fresh start transition method is no longer available because that method results in the elimination of pretransition gain or loss, and (if it were available) it could be opportunistically used by taxpayers to eliminate their pretransition gain. 88 FR 78150 and 78156.

The final regulations also clarify that the rule in §1.988-1(a)(10)(i), which provides that transactions between a taxpayer and its QBU generally are not section 988 transactions, applies only to disregarded transactions. Thus, a nonfunctional currency transaction between a partner and a partnership could be treated as a section 988 transaction even though the partnership is treated as a QBU subject to section 987.

IX. Comments and Changes to Proposed §1.987-10: Transition Rules

Proposed §1.987-10 would provide transition rules for the first year in which the section 987 regulations are applicable. In particular, proposed §1.987-10(e) would provide rules for determining and recognizing pretransition gain or loss with respect to each of a taxpayer's QBUs.

A. *Computation of Pretransition Gain or Loss*

1. Taxpayers that applied section 987 using an eligible pretransition method

Under the 2023 proposed regulations, the computation of pretransition gain or loss would differ depending on how the taxpayer applied section 987 before the transition date. If the taxpayer applied section 987 to a section 987 QBU using an eligible pretransition method (as described in part IX.B of this Summary of Comments and Explanation of Revisions), the owner would use that method to compute pretransition gain or loss. Proposed §1.987-10(e)(2). The owner's pretransition gain or loss would be equal to the amount of section 987 gain or loss that it would have recognized under the eligible pretransition method if the QBU terminated on the day before the transition date, with certain adjustments. Proposed §1.987-10(e)(2)(i)(A).

Under proposed §1.987-10(e)(2)(i)(B), the amount of pretransition gain or loss would be increased or reduced by the owner functional currency net value adjustment ("OFCNV adjustment"), which reflects any change to the basis of the section 987 QBU's assets (net of liabilities) that occurs as a result of the transition. For example, if a taxpayer applied an earnings only method under which currency gain or loss on the QBU's capital was not recognized at the time of a remittance but was separately tracked and accounted for in determining the basis of distributed assets, the currency gain or loss on capital would be accounted for as part of the OFCNV adjustment.

Two comments were received relating to the OFCNV adjustment. One comment requested that taxpayers be permitted to use the CTA prepared for financial accounting purposes rather than making the OFCNV adjustment. The comment asserted that taxpayers applying an earnings only method might not have the information necessary to compute the OFCNV adjustment.

The final regulations do not permit taxpayers to use the CTA in lieu of making the OFCNV adjustment. As explained in part V.A.2 of this Summary of Comments and Explanation of Revisions, the CTA amount may be substantially different from the amount of section 987 gain or loss that is properly taken into account for tax purposes. Moreover, it should not be unduly burdensome for a taxpayer to compute the OFCNV adjustment because the relevant information is already needed to apply the taxpayer's existing pretransition method.

Another comment recommended that, in the case of taxpayers applying an earnings only method, currency gain or loss with respect to the QBU's capital should not be taken into account in determining pretransition gain or loss (which is ultimately recognized as section 987 gain or loss after the transition date). The comment noted that taxpayers may have adopted the earnings only method to reduce the size of their section 987 gain or loss pools and that the earnings only method serves to mitigate the potential for selective recognition of large section 987 losses. Therefore, the comment requested that the OFCNV adjustment instead be taken into account as an adjustment to asset basis.

The Treasury Department and the IRS agree that, for taxpayers applying an earnings only method, accounting for the OFCNV adjustment in determining the basis of a section 987 QBU's assets would produce a reasonable result that is consistent with these taxpayers' pretransition method. Accordingly, under the final regulations, if a taxpayer applied an earnings only method before the transition date and does not make a current rate election for the taxable year beginning on the transition date, the historic rate assigned to the section 987 QBU's historic assets (other than inventory) is equal to the exchange rate that would have been used to translate those assets if they had been distributed to the owner on the day before the transition date (the "pretransition translation rate"). *See* §1.987-10(d)(3)(ii). As a result, no OFCNV adjustment is made with respect to those assets, but currency gain or loss related to those assets will be accounted for as the assets are sold or depreciated under §1.987-3. For taxpayers that make a current rate election (and thus will not take historic rates into account under §1.987-3), currency gain or loss on the QBU's capital must be accounted for in determining pretransition gain or loss. *See* §1.987-10(d)(3)(i) and (e)(2)(i)(B).

A comment raised a question as to whether the delegation of regulatory authority under section 987(3) is self-executing. The comment suggested that, if section 987(3) is not self-executing, then it might not be appropriate to attribute pretransition gain or loss to taxpayers that have not accounted for section 987 gain or loss before the transition date. The Treasury Department and the IRS have concluded that section 987(3) is self-executing because it provides a mandatory delegation under which the Secretary is directed to determine how (rather than whether) the owner of a section 987 QBU should make proper adjustments in computing its taxable income. *See*, *e.g.*, *15 W. 17th St. LLC v. Commissioner*, 147 T.C. 557 (2016) (articulating standard for determining whether a statute is self-executing in the absence of regulations); *Est. of Neumann v. Commissioner*, 106

T.C. 216 (1996) (holding delegation was self-executing because it related to how, rather than whether, the statute applied). Therefore, taxpayers currently are obligated to determine section 987 gain or loss in a reasonable manner and must account for pretransition gain or loss once the regulations become applicable.

2. Taxpayers that did not apply section 987 using an eligible pretransition method

Under proposed §1.987-10(e)(3), taxpayers that did not apply an eligible pretransition method would be required to determine pretransition gain or loss by applying a simplified version of the computation described in §1.987-4(d) to determine unrecognized section 987 gain or loss ("annual unrecognized section 987 gain or loss") for each taxable year since the section 987 QBU's inception. Proposed §1.987-10(e)(3)(iii). Pretransition gain or loss would be reduced by any section 987 gain or loss recognized before the transition date. Proposed §1.987-10(e)(3)(ii)(B).

Comments asserted that the method provided in proposed §1.987-10(e)(3) could be burdensome to apply and difficult to administer. Some comments recommended that taxpayers should not be required to compute annual unrecognized section 987 gain or loss for each taxable year since the QBU's inception. Instead, the comments suggested that the final regulations provide a reasonable cutoff date before which pretransition gain or loss would not be computed. Another comment requested that taxpayers be permitted to determine pretransition gain or loss using the earnings and capital method described in the 1991 proposed regulations, as this would avoid the need to prepare tax basis balance sheets. A further comment recommended adoption of a de minimis rule for taxpayers with minimal pretransition gain or loss.

The Treasury Department and the IRS agree that, when a QBU has been operating for a long period, computing annual unrecognized section 987 gain or loss for all taxable years since the QBU's inception could be burdensome. Accordingly, the final regulations provide a cutoff date of September 7, 2006, which is the date on which proposed section 987 regulations were published in the **Federal Register** (71 FR 52876) (the "2006 proposed regulations"). Under the final regulations, taxpayers that did not apply an eligible pretransition method must compute pretransition gain or loss only for taxable years beginning on or after September 7, 2006. The publication date of the 2006 proposed regulations is an appropriate cutoff date for this purpose because the 2006 proposed regulations contained transition rules that were conditioned on the application of section 987 using a reasonable method. *See* §1.987-10(a)(2) of the 2006 proposed regulations.

The final regulations also provide a de minimis rule to reduce the compliance burden on small businesses that own section 987 QBUs.[6] Under the de minimis rule, a qualifying taxpayer may elect to treat all QBUs that fall below the de minimis threshold as having no pretransition gain or loss. To qualify for the de minimis rule, the owner of a section 987 QBU must have gross receipts that fall below the threshold for the small business exception in section 163(j)(3) (that is, the owner must have gross receipts of $25 million or less, indexed to inflation and averaged over the prior 3-year period). If this test is met, the de minimis rule applies to any section 987 QBU with gross assets of less than $10 million (averaged over the same 3-year period and taking into account the assets of all section 987 QBUs in the same country that are owned by the same owner or a member of its controlled group).

The final regulations do not permit taxpayers to apply an earnings and capital method in lieu of computing annual unrecognized section 987 gain or loss under §1.987-10(e)(3). However, as explained in part V.A.1 of this Summary of Comments and Explanation of Revisions, the rules for computing unrecognized section 987 gain or loss for a taxable year under §1.987-4(d) have been modified so that they can be applied without the need for tax basis balance sheets. As a result, the method provided in §1.987-10(e)(3) can similarly be applied without tax basis balance sheets (that is, by computing QBU net value using the formula provided in §1.987-4(e)(2)(iii)).

B. *Definition of an Eligible Pretransition Method*

Under the 2023 proposed regulations, an eligible pretransition method would be defined to include a reasonable application of the earnings and capital method described in the 1991 proposed regulations, any other reasonable method that produces the same total amount of income as the earnings and capital method over the life of the owner, or an earnings only method that does not produce the same total amount of lifetime income as an earnings and capital method (subject to certain restrictions, including a consistency requirement). Proposed §1.987-10(e)(4)(i) through (iii). The owner must have applied the eligible pretransition method with respect to each taxable year beginning before the transition date in which it was the owner of the section 987 QBU. Proposed §1.987-10(e)(4). For this purpose, a method under which the owner of a section 987 QBU defers the recognition of section 987 gain or loss until the section 987 QBU is terminated, sold, or liquidated is not a reasonable method. Proposed §1.987-10(e)(4)(iv).

Comments requested clarification concerning the definition of an eligible pretransition method. The comments noted that some taxpayers have applied the 1991 proposed regulations with modifications; for example, some taxpayers apply an annual netting convention to determine the amount of a remittance or treat a group of QBUs with the same functional currency as a single QBU. Other comments indicated that taxpayers may not account for frequently recurring intercompany transactions in computing their section 987 gain or loss.

One comment suggested that taxpayers should be treated as having applied an eligible pretransition method so long as they made a good faith effort to apply section 987 using a reasonable method. Another comment recommended that taxpayers

[6] Although taxpayers that own section 987 QBUs generally are not small businesses, this rule is intended to limit the compliance burden for small businesses that may be affected.

that have consistently relied on their CTA account as an estimate of unrealized section 987 gain or loss should be considered to have applied an eligible pretransition method (and thus should be permitted to use their CTA account to determine the amount of pretransition gain or loss).

Another comment suggested that a CFC that has consistently applied a reasonable method since the enactment of the Tax Cuts and Jobs Act ("TCJA"), Public Law 115-97, 131 Stat. 2054 (2017), should be treated as having applied an eligible pretransition method, even if the method was not applied in previous taxable years. In particular, the comment recommended that an owner that began applying an earnings only method described in proposed §1.987-10(e)(4)(iii) after the TCJA was enacted should be deemed to meet the consistency requirement of proposed §1.987-10(e)(4)(iii)(B).

In response to these comments, the final regulations clarify and expand the definition of an eligible pretransition method under §1.987-10(e)(4). The definition is intended broadly to include any method that complies with the statutory requirements of section 987 in a reasonable manner.[7]

1. Errors made in applying a pretransition method and certain consistent practices that are not treated as errors

The final regulations provide that a taxpayer is treated as applying an eligible pretransition method even if the taxpayer made an error in the application of its method or did not apply the method in all taxable years in which it was the owner of the section 987 QBU. §1.987-10(e)(4)(iv). However, taxpayers are required to compute pretransition gain or loss under §1.987-10(e)(2) as though the eligible pretransition method had been applied without error for all prior taxable years. Thus, for example, if a taxpayer made an error in applying its method for a prior year, the deemed termination amount under §1.987-10(e)(2)(i)(A) is equal to the amount of section 987 gain or loss the taxpayer would have recognized on termination if it had not made the error and its section 987 QBU terminated on the day before the transition date.

If a taxpayer consistently used a reasonable convention to apply section 987 before the transition date, the taxpayer must use the same convention in determining pretransition gain or loss under §1.987-10(e)(2). *See* §1.987-10(e)(4)(v)(B)(*1*). Thus, unlike a taxpayer that made an error in applying its pretransition method, a taxpayer that used a reasonable convention would not be required to recompute pretransition gain or loss without regard to the convention. Similarly, if a taxpayer had a consistent practice under which it did not account for frequently recurring disregarded transactions in determining the amount of section 987 gain or loss recognized upon a remittance, this practice is not treated as an error. *See* §1.987-10(e)(4)(v)(B)(*2*). However, this rule does not apply unless the taxpayer reasonably accounted for the disregarded transactions in determining the amount of unrecognized section 987 gain or loss with respect to the section 987 QBU (for example, in the case of a taxpayer applying the 1991 proposed regulations, by adjusting the equity and basis pools to reflect the amount of each transfer).

2. Timing for application of an eligible pretransition method

The final regulations provide that a method of applying section 987 is not an eligible pretransition method unless it was applied on at least one tax return filed before November 9, 2023 (when the 2023 proposed regulations were filed with the Federal Register). *See* §1.987-10(e)(4). Thus, a taxpayer that first adopted a reasonable method in the first taxable year after the TCJA was enacted would be treated as applying an eligible pretransition method, but a method adopted after November 9, 2023, would not qualify. Similarly, the final regulations modify the consistency requirement for the earnings only method under §1.987-10(e)(4)(iii)(B) to require consistent application for all taxable years since the first taxable year in which the owner applied an eligible pretransition method. As a result, an owner that began applying the earnings only method after the TCJA was enacted (and did not previously apply a different eligible pretransition method) would meet this requirement.

3. Reliance on the CTA

Under the final regulations, a method that relies on the CTA determined for financial accounting purposes would not qualify as an eligible pretransition method; thus, taxpayers relying on CTA computations must determine pretransition gain or loss using the method provided in §1.987-10(e)(3). As discussed in part V.A.2 of this Summary of Comments and Explanation of Revisions, because the amount of the CTA can be substantially different from the amount of section 987 gain or loss properly computed for tax purposes, reliance on the CTA could result in the recognition of significant amounts of artificial pretransition gain or loss.

C. *Recognition of Pretransition Gain or Loss*

In general, under the proposed regulations, pretransition gain is treated as net unrecognized section 987 gain, while pretransition loss is treated as suspended section 987 loss. Proposed §1.987-10(e)(5)(i)(A) and (B). This rule is intended to prevent taxpayers from selectively recognizing pretransition loss while deferring pretransition gain until the year of a remittance. Alternatively, taxpayers could elect to amortize pretransition gain or loss over a period of ten years beginning on the transition date. Proposed §1.987-10(e)(5)(ii).

A comment recommended that pretransition loss should not be treated as suspended section 987 loss in the first taxable year in which the section 987 regulations apply. Instead, the comment recommended that pretransition loss should be treated as net unrecognized section 987 loss upon transition, which would later become suspended in the year of a remittance. The comment noted that this would create parity between pretransition loss and pretransition gain, which is treated as net unrecog-

[7] In certain instances, a method that does not constitute a reasonable application of section 987 is treated as an eligible pretransition method in order to reduce the compliance burden of transitioning onto the section 987 regulations.

nized section 987 gain in the first taxable year in which the regulations apply.

Another comment recommended that, instead of determining pretransition gain or loss separately with respect to each QBU, the total amount of pretransition gain or loss in each category should be aggregated and netted among all QBUs of the same owner, with the net amounts reallocated to each QBU on a pro rata basis. In the case of a consolidated group or a group of related CFCs, the comment suggested further netting between all members of the consolidated group or group of related CFCs, respectively.

With respect to the amortization election under proposed §1.987-10(e)(5)(ii), a comment suggested that taxpayers should be allowed to elect a shorter amortization period in which to recognize pretransition gain or loss (either four or five years), which would better align with certain taxpayers' internal forecasting and planning windows. A comment also requested clarification as to how the amortization election applies with respect to a terminating QBU (that is, a section 987 QBU that terminated after November 9, 2023, and before the taxable year in which the section 987 regulations are generally applicable).

The final regulations provide that, if a current rate election is in effect in the taxable year beginning on the transition date (and an annual recognition election is not in effect), pretransition gain or loss is treated as net unrecognized section 987 gain or loss. Thus, pretransition losses are treated the same way as pretransition gains. However, if a current rate election is not in effect (or an annual recognition election is in effect) in the taxable year beginning on the transition date, pretransition loss is treated as suspended section 987 loss upon transition. This rule is necessary to prevent pretransition loss from being recognized without limitation.

The final regulations do not permit aggregation and netting of pretransition gain or loss within the same category. Absent an amortization election, the source and character of pretransition gains and losses generally will not be assigned in the taxable year beginning on the transition date, so it would not be possible to net gains and losses separately within each recognition grouping. In addition, aggregation and netting would make the transition rules more complicated and would increase the burden of administering these rules. Finally, taxpayers that make the amortization election can, as a practical matter, achieve the effect of netting pretransition gains and losses, because those gains and losses will be recognized over the same ten-year period.

The final regulations retain the ten-year amortization period under §1.987-10(e)(5)(ii) and do not permit taxpayers to elect a shorter amortization period. The Treasury Department and the IRS have determined that a uniform amortization period should apply to all electing taxpayers to prevent the potential for whipsaw that could result from taxpayers with losses electing shorter amortization periods than taxpayers with gains. In addition, a ten-year period is appropriate given the expected magnitude of the pretransition gains and losses that are subject to amortization. However, taxpayers that do not make the amortization election will retain some control over when gains and losses are recognized (by choosing whether or not to make remittances). The final regulations also expand the acceleration rule of §1.987-10(e)(5)(ii)(B) to cover transactions entered into with a principal purpose of avoiding the recognition of pretransition gain that is subject to the amortization election. *See* §1.987-10(e)(5)(ii)(B)(*1*).

In addition, the final regulations clarify the application of the amortization election in the case of a terminating QBU. Under §1.987-10(e)(5)(ii)(C), any deferred section 987 gain or suspended section 987 loss with respect to a terminating QBU that has not been recognized before the first taxable year in which the section 987 regulations are generally applicable is subject to amortization beginning in that year. However, the final regulations do not modify the treatment of section 987 gain or loss that has already been recognized before the transition date; thus, such section 987 gain or loss is not subject to amortization.

X. Comments and Changes to Proposed §1.987-11: Suspended Section 987 Loss Relating to Certain Elections; Loss-to-the-Extent-of-Gain Rule

Proposed §1.987-11 provides rules that suspend the recognition of section 987 loss in connection with certain elections and rules under which suspended section 987 loss is recognized to the extent of recognized section 987 gain (the "loss-to-the-extent-of-gain rule").

A. *Loss Suspension Rule*

1. In general

Under proposed §1.987-11(c), in a taxable year in which a current rate election is in effect (and an annual recognition election is not in effect), any section 987 loss that would otherwise be recognized as a result of a remittance or termination would be treated as suspended section 987 loss.

A comment requested that the loss suspension rule of proposed §1.987-11(c) be eliminated because it prevents taxpayers from recognizing section 987 losses in connection with legitimate commercial transactions. The comment noted that the recognition of section 987 loss often is not the primary factor in determining whether a taxpayer causes its branch to make a remittance.

The final regulations retain the loss suspension rule in §1.987-11(c). Congress specifically authorized loss limitation rules to address the potential for selective recognition of losses. *See* section 989(c)(2). These rules are integral to the current rate election; without a loss limitation the current rate election would create opportunities for abuse. Although remittances are often made for non-tax reasons, taxpayers can cause section 987 QBUs to make otherwise disregarded transfers for the purpose of recognizing large section 987 losses, and taxpayers have the ability to structure transactions in ways that defer the recognition of section 987 gain.

However, the final regulations limit the scope of the loss suspension rule to cover transactions that would otherwise result in the recognition of substantial section 987 losses. Under §1.987-11(c)(2), if a current rate election is in effect, section 987 loss is not suspended unless the amount of section 987 loss subject to suspension in the taxable year exceeds the lesser of $3 million or two percent of the controlled group's gross income. This threshold is applied collectively to the section 987 loss of the owner and all members of the owner's controlled group. This rule is expected to reduce the compliance burden of tracking suspended section 987 losses, particularly for taxpayers with small section 987 QBUs.

2. Exception for QBUs with de minimis historic assets

Comments requested an exception from the loss suspension rule for section 987 QBUs with minimal historic assets (such as financial institutions and insurance companies). Alternatively, a comment recommended that the loss suspension rule should apply solely to section 987 loss associated with historic items.

The final regulations do not provide an exception to the loss suspension rule for taxpayers with a de minimis amount of historic assets. Such an exception would be difficult to administer because it would require long-term tracking to ensure that the de minimis threshold was met in all prior taxable years over which the pool of net unrecognized section 987 gain or loss accrued. Further, for taxpayers with minimal historic assets, the compliance burden of applying the default rules of the final regulations (that is, the rules that apply in the absence of a current rate election) is expected to be more limited. A taxpayer that does not make a current rate election generally would not be subject to the loss suspension rule.

Similarly, under the final regulations, the loss suspension rule of §1.987-11(c) is not limited to section 987 loss associated with historic items. Under §1.987-4, the pool of net unrecognized section 987 gain or loss is determined with respect to a section 987 QBU as a whole. Separate computations of unrecognized section 987 loss associated with marked and historic items, respectively, would add significant complexity. Moreover, concerns related to selective recognition of section 987 loss can arise with respect to both marked and historic items.

B. *Loss-to-the-Extent-of-Gain Rule*

Under proposed §1.987-11(e), an owner of a section 987 QBU recognizes suspended section 987 loss to the extent that it recognizes section 987 gain in the same recognition grouping (that is, section 987 gain that has the same source and character as the suspended section 987 loss) in the same taxable year. As explained in the preamble to the 2023 proposed regulations, this rule is intended to prevent taxpayers from selectively recognizing section 987 losses when a current rate election is in effect. 88 FR 78139.

1. Lookback rule

The 2023 proposed regulations do not include a lookback rule under which suspended section 987 loss can be recognized to the extent of section 987 gain recognized in previous taxable years. The preamble to the 2023 proposed regulations expressed concern that taxpayers might exploit a lookback rule by selectively triggering the recognition of section 987 gain in a taxable year in which the gain could be offset by losses or in which a taxpayer had excess foreign tax credits. 88 FR 78139.

Several comments recommended adoption of a lookback rule. Alternatively, a comment recommended modifying proposed §1.987-11(e) to permit taxpayers to carry back section 987 losses to earlier years. Comments posited that, even if section 987 gain recognized in a previous year is offset by a loss carryforward or other tax attribute, the section 987 gain would still have a net impact on U.S. tax because the attribute would no longer be available to be utilized in subsequent years. However, the same comment expressed a minority view that a lookback rule would afford some potential for abuse, and suggested consideration of an anti-abuse rule targeting remittances that do not have economic effect. One comment recommended that the lookback period for section 987 gains should include years ending before the transition date, while another comment suggested that the lookback period should include only post-transition years.

The Treasury Department and the IRS agree that a lookback rule would allow for more evenhanded treatment of section 987 gains and losses when section 987 gain is recognized in an earlier taxable year and that a lookback rule could be tailored to prevent abuse. Accordingly, the final regulations provide that suspended section 987 loss is recognized to the extent of net section 987 gain recognized in the current year and the three preceding taxable years. *See* §1.987-11(e)(3). Taxable years beginning before the transition date are not included in the lookback period, given the substantial flexibility taxpayers have had in determining the timing, amount, and character of section 987 gain or loss recognized before the applicability date of the final regulations.

Under an anti-abuse rule, section 987 gain is disregarded for purposes of the loss-to-the-extent-of-gain rule if it is recognized with a principal purpose of reducing U.S. Federal income tax liability, including over multiple taxable years. *See* §1.987-11(e)(3)(v). For example, this rule would apply if an owner recognizes section 987 gain in a taxable year ("year 1") in which the section 987 gain is offset by a tax attribute that would not otherwise be used, the section 987 gain is recognized with a principal purpose of releasing suspended section 987 loss in a subsequent taxable year ("year 2"), and the net effect of recognizing both the section 987 gain and the suspended section 987 loss would reduce the combined U.S. Federal income tax liability for years 1 and 2. In determining whether such a principal purpose exists, one relevant factor is the extent to which a remittance does not result in a sustained economic contraction of the section 987 QBU (over a period of at least 12 months). Thus, for example, if a section 987 QBU makes a remittance giving rise to the recognition of section 987 gain, and the owner makes an offsetting contribution to the section 987 QBU within 12 months of the remittance, the section 987 gain may be disregarded for purposes of the loss-to-the-extent-of-gain rule.

The lookback period generally is limited to three years, because a longer lookback period would require additional tracking of section 987 gains recognized in prior taxable years and would increase the compliance and administrative burden of the section 987 regulations. In addition, this rule is consistent with other Code provisions that limit loss carryforward or carryback periods to a fixed number of years. *See*, *e.g.*, section 1212(a)(1) (generally permitting capital losses to be carried forward for five years and carried back for three years). Moreover, it may be difficult to enforce the anti-abuse rule in §1.987-11(e)(3)(v) with respect to transactions occurring more than three years before the taxable year in which suspended section 987 loss is recognized.

The final regulations provide a different lookback period for taxpayers that make both an annual recognition election and a current rate election. For these taxpayers, the lookback period includes all taxable years in which both elections are continuously in effect. *See* §1.987-11(e)(3)(iv)(B). As a result, for purposes of applying the loss-to-the-extent-of-gain rule, the total amount of section 987 gain recognized under the annual recognition election for all taxable years in which both elections are continuously in effect is offset by the total amount of section 987 loss recognized under the annual recognition election for all taxable years in which both elections are continuously in effect. As explained in the preamble to the proposed regulations, the Treasury Department and the IRS are concerned that, in the absence of such a rule, taxpayers would be able to recognize net losses on a cumulative basis for the taxable years to which the annual recognition election applies. 88 FR 78140. In addition, the tracking burden in this context should be more limited because losses generally are not suspended in taxable years in which an annual recognition election is in effect.

In general, following a transaction described in section 381(a), section 987 gain recognized by the transferor corporation in the three years preceding the transaction is taken into account for purposes of the lookback rule. *See* §1.987-11(e)(5)(i). However, this rule does not apply in the case of an inbound reorganization or liquidation. *See* §1.987-11(e)(5)(ii). Thus, section 987 gain recognized by the foreign transferor corporation (which may have been subject to a lower effective tax rate) cannot be used to release suspended section 987 loss of the domestic acquiring corporation.

2. Application of the loss-to-the-extent-of-gain rule at the owner level

Under proposed §1.987-11(e), the loss-to-extent-of-gain rule is applied separately to each owner with respect to all of its section 987 QBUs. Comments asserted that the loss-to-the-extent-of-gain rule could produce harsh results when one CFC recognizes section 987 gain and a related CFC has suspended section 987 loss. One comment noted that concerns about selective recognition of section 987 loss should be mitigated to the extent that a different CFC in the same group recognizes section 987 gain.

Another comment recommended that, with respect to section 987 gain or loss that is characterized as tested income, the loss-to-the-extent-of-gain rule should be applied at the level of the U.S. shareholder with respect to all section 987 QBUs of CFCs owned by the U.S. shareholder, consistent with the general framework of section 951A. Under this approach, the excess of the U.S. shareholder's pro rata share of section 987 losses of any CFC attributable to a tested income group over its pro rata share of section 987 gains attributable to the same tested income group would be suspended (and available for recognition to the extent of the U.S. shareholder's pro rata share of section 987 gains recognized in future years). Another comment recommended that the loss-to-the-extent of gain rule should be applied to a group of related CFCs by treating the group as a single owner. Under this approach, one CFC could recognize suspended section 987 loss to the extent that another CFC recognized section 987 gain.

The final regulations generally apply the loss-to-the-extent of gain rule separately to each owner, taking into account section 987 gain or loss with respect to all of the owner's section 987 QBUs. The final regulations do not apply the loss-to-the-extent of gain rule at the level of the U.S. shareholder. Because section 987 gain or loss is a CFC-level income item that is taken into account in computing each CFC's taxable income and earnings and profits, a U.S. shareholder level loss limitation rule could reach inappropriate results for minority shareholders and would be difficult to administer. For example, if a CFC is owned by multiple U.S. shareholders, application of the loss-to-the-extent-of-gain rule at the U.S. shareholder level would require multiple separate computations to determine the suspended section 987 loss recognized by a single CFC.

Similarly, the final regulations do not treat a group of related CFCs as a single owner for purposes of the loss-to-the-extent-of-gain rule. A CFC grouping rule would make the loss-to-the-extent-of-gain-rule more complex and more difficult to administer. Moreover, under a CFC grouping rule, a CFC could recognize suspended section 987 loss as a result of a different CFC's recognition of section 987 gain in the same recognition grouping in a taxable year in which the loss cannot be utilized.

3. Expansion of the loss-to-the-extent-of-gain rule

A comment recommended expansion of the loss-to-the-extent-of-gain rule so that suspended section 987 loss could be recognized to the extent of any income recognized by the owner (including but not limited to section 987 gain) that has the same source and character as the suspended section 987 loss. Another comment recommended that suspended section 987 loss should be recognized to the extent of any section 987 gain recognized by the owner, even if the section 987 gain is in a different recognition grouping. The comment suggested that the requirement for section 987 gain to be in the same recognition grouping as suspended section 987 loss does not serve the policy goals of section 987, and that concerns relating to mismatches between the source and character of section 987 gains and losses are adequately policed by other provisions of the Code.

The final regulations do not expand the scope of the loss-to-the-extent of gain rule to cover taxable income other than section 987 gain. Taxable income other than section 987 gain does not release suspended section 987 loss under the loss-to-the-extent-of-gain rule because this rule is intended to target selective recognition of section 987 loss and deferral of section 987 gain.

In addition, the final regulations retain the rule that section 987 gain can only release suspended section 987 loss in the same recognition grouping. This rule ensures that the loss-to-the-extent-of-gain rule effectively limits selective recognition of losses pursuant to the authority provided in section 989(c)(2). In particular, it prevents taxpayers from avoiding the loss limitation by recognizing gains that are subject to a low rate of tax (or are not subject to U.S. tax).

As explained in part VII.B of this Summary of Comments and Explanation of Revisions, the final regulations allow section 987 gain or loss to be assigned to multiple subpart F income groups. Therefore, each separate subpart F income group (as defined in §1.960-1(d)(2)(ii)(B)) constitutes a separate recognition grouping. *See* §1.987-11(f)(2)(ii). However, as explained in part VII.B.2 of this Summary of Comments and Explanation of Revisions, taxpayers can reduce the number of subpart F recognition groupings by making the section 988 characterization election provided in §1.987-6(b)(2)(i)(C).

4. Application to terminating QBUs

A comment requested clarification concerning the application of the loss-to-the-extent-of-gain rule in the case of a terminating QBU. The final regulations clarify that, when a terminating QBU has suspended section 987 loss in a taxable year before the final regulations are generally applicable, section 987 gain with respect to a taxpayer's other section 987 QBUs is assigned to a recognition grouping under the method applied by the taxpayer before the transition date. The owner recognizes suspended section 987 loss with respect to a terminating QBU only to the extent of its net section 987 gain in the same recognition grouping for the taxable year.

5. SRLY rule relating to suspended section 987 losses

When a corporation that is the owner of a section 987 QBU joins a consolidated group, the corporation may have suspended section 987 losses that arose in earlier years. As explained in the preamble to the 2023 proposed regulations, the regulations issued under the authority of section 1502 generally limit a consolidated group's ability to use tax attributes generated in separate return years (as defined in §1.1502-1(e)). 88 FR 78154. The Treasury Department and the IRS requested comments on how rules similar to the rules of §1.1502-21(c) (limiting the use of net operating losses) should apply to suspended and deferred section 987 losses. *Id*. No comments were received in response to this request.

To prevent inappropriate trafficking of section 987 losses, §1.987-11(e)(6)(ii) of the final regulations provides that the separate return limitation year (SRLY) limitation principles of §1.1502-21(c) apply to suspended section 987 losses that arose in separate return years. The rule in §1.987-11(e)(6)(ii) is based on the SRLY rules for capital loss carryovers in §1.1502-22(c). To simplify the administration of this rule, when a corporation that is the owner of a section 987 QBU joins a consolidated group, the SRLY limitation is not applied separately to each recognition grouping determined under §1.987-11(f), but rather to the corporation's section 987 losses overall.

Because deferred section 987 losses under §1.987-12 are not subject to a loss-to-the-extent-of-gain rule, but rather are treated similarly under the section 987 regulations to other unrecognized section 987 losses, the SRLY limitation in §1.987-11(e)(6)(ii) does not apply to such losses.

XI. Comments and Changes to Proposed §1.987-13: Suspended Section 987 Loss Upon Terminations

Proposed §1.987-13 would provide suspended loss rules that apply in connection with certain transactions in which a section 987 QBU or a successor suspended loss QBU terminates.

A. *Successor Rules*

Under the 2023 proposed regulations, if an owner has suspended section 987 loss with respect to a section 987 QBU that terminates, an eligible QBU that holds the assets of the section 987 QBU after the termination would be treated as a successor suspended loss QBU if it meets three requirements. Proposed §1.987-13(b)(1)(i). First, a significant portion of the assets of the terminating section 987 QBU must be reflected on the books and records of the eligible QBU. Second, the eligible QBU must carry on a trade or business of the section 987 QBU. Finally, the eligible QBU must be owned by the owner of the section 987 QBU or by a member of its controlled group (the owner of the successor is referred to as the "successor suspended loss QBU owner"). Following a termination, if the terminated section 987 QBU has a successor, suspended section 987 loss with respect to the section 987 QBU would be attributed to the successor. Similar successor rules would apply upon termination of a successor suspended loss QBU. Proposed §1.987-13(c)(1)(i).

If a section 987 QBU or successor suspended loss QBU terminates without a successor, the owner would recognize its cumulative suspended section 987 loss with respect to the QBU. Proposed §1.987-13(b)(2) and (c)(2). Similarly, the cumulative suspended section 987 loss with respect to a successor suspended loss QBU would be recognized if the original suspended loss QBU owner ceases to be a member of the same controlled group as the successor suspended loss QBU owner due to the transfer of an ownership interest in the successor suspended loss QBU owner. Proposed §1.987-13(d).

A comment recommended that the definition of a successor suspended loss QBU should be aligned with the definition of a successor deferral QBU as provided in proposed §1.987-12(g)(2), so that the same definition would apply for both purposes. The final regulations generally retain the definition of a successor suspended loss QBU provided in the proposed regulations because this definition is needed to ensure that suspended section 987 loss can be recognized (in excess of section 987 gain) only when the trade or business of a section 987 QBU ceases to be operated by a member of the same controlled group. The successor rule in §1.987-12(g)(2) (which requires the successor to itself be a section 987 QBU) would not serve this function, because it would require suspended section 987 loss to be recognized when a section 987 QBU is transferred to a related owner that has the same functional currency as the section 987 QBU.

B. *Elimination or Limited Recognition of Suspended Section 987 Loss Following Certain Transactions*

Proposed §1.987-13(e), (f), and (g) would provide rules that eliminate or limit the recognition of suspended section 987 loss following certain transactions. First, under proposed §1.987-13(e), if the original suspended loss QBU owner ceases to be a member of the same controlled group as the successor suspended loss QBU owner due to the transfer of an ownership interest in the original suspended loss QBU owner, the original suspended loss QBU owner's suspended section 987 loss would cease to be attributable to any section 987 QBU or successor suspended loss QBU. After the transaction, the owner's suspended section 987 loss can be recognized under §1.987-11(e) to the extent that the owner recognizes section 987 gain; however, the suspended section 987 loss cannot be recognized under proposed §1.987-13(b)(2), (c)(2), or (d). This rule would prevent taxpayers from transferring the stock of the original suspended loss QBU owner out of its controlled group for the purpose of selectively recognizing suspended section 987 loss, while retaining the assets and activities of the section 987 QBU in the hands of a different controlled group member.

Proposed §1.987-13(f) would provide that, if an original suspended loss QBU owner ceases to exist as a result of a transaction in which there is no successor described in section 381(a) (for example, as a result of a section 331 liquidation), then any suspended section 987 loss that is not recognized after applying the loss-to-the-extent-of-gain rule cannot be recognized and is eliminated. This rule is intended to prevent taxpayers from entering into section 331 liquidations in order to trigger the recognition of suspended section 987 loss.

Similarly, under proposed §1.987-13(g), if an owner of a section 987 QBU with suspended section 987 loss, or an original suspended loss QBU owner, ceases to exist in an inbound section 332 liquidation or in an inbound reorganization described in section 381(a)(2), then any suspended section 987 loss of the owner or original suspended loss QBU owner that is not recognized after application of the loss-to-the-extent-of-gain rule under proposed §1.987-11(e) would be eliminated. This rule would prevent suspended section 987 loss that was generated offshore from being imported into the United States.

Several comments requested that the rules of proposed §1.987-13(e) through (g) be replaced with anti-abuse rules tied to the purpose for which a taxpayer enters into the relevant transaction. One comment noted that if a CFC liquidates into its U.S. shareholder and a current rate election is not in effect, the transaction results in a termination of the CFC's section 987 QBUs under §1.987-8, and the CFC recognizes its net unrecognized section 987 gain or loss immediately before the liquidation. The comment proposed that suspended section 987 loss should similarly be recognized in connection with an inbound liquidation.

Other comments recommended that, following a section 331 liquidation or inbound transaction, suspended section 987 loss should be amortized over a ten-year period or added to the acquiring corporation's outside stock basis. One comment suggested that the suspended section 987 loss should be allocated pro rata among the U.S. shareholder's other foreign entities that own section 987 QBUs. Another comment requested that §1.987-13(f) be modified to provide that suspended section 987 loss is recognized to the extent of the owner's overall gain (not limited to section 987 gain) recognized in connection with the section 331 liquidation. One comment suggested that, in connection with an inbound transaction, suspended section 987 loss could be recognized to the extent of the inbounded section 987 gain.

The Treasury Department and the IRS have determined that, in order to facilitate the current rate election (which can have the effect of enlarging the pools of unrecognized section 987 gain or loss), effective loss limitation rules are needed to prevent the selective recognition of section 987 losses by, for example, entering into a section 331 liquidation, inbound liquidation or reorganization, or a transfer of the original suspended loss QBU owner. Further, an anti-avoidance rule tied to the taxpayer's subjective purpose for entering into a particular transaction would be difficult to administer and, consequently, would not be an adequate safeguard against abuse given the critical function served by the loss limitation rules. A subjective anti-abuse rule would also provide less certainty for taxpayers and the IRS. Therefore, the final regulations generally retain the rules of proposed §1.987-13(e) through (g).

The final regulations do not permit suspended section 987 loss to be amortized by the acquiring corporation over a ten-year period following an inbound transaction or section 331 liquidation because this would nevertheless facilitate loss importation (in the case of an inbound transaction), even though the benefit would only be recognized over time, or would allow for losses to be carried over to the acquirer in a transaction not described in section 381(a) (in the case of a section 331 liquidation). Similarly, reallocating losses to foreign entities other than the acquiring corporation would be inconsistent with the principles of section 381 and would be unduly complex. Adding suspended section 987 loss of a CFC to the outside basis of a domestic acquiring corporation's stock would have the same effect as loss importation (because the increased basis could reduce the taxable income of the domestic corporation's shareholders upon a sale of stock) and would also shift losses in a manner that is contrary to general tax principles.

The final regulations also do not permit suspended section 987 loss to be recognized to the extent of gain (other than section 987 gain) recognized in connection with a section 331 liquidation. As explained in part X.B.3 of this Summary of Comments and Explanation of Revisions, the loss-to-the-extent of gain rule generally does not allow suspended section 987 loss to be recognized in excess of section 987 gain. If a different rule were adopted for section 331 liquidations, taxpayers could enter into a section 331 liquidation in order to step up the basis of their assets, with any gain recognized with respect to those assets being offset by the recognition of suspended section 987 loss.

However, consistent with the 2023 proposed regulations, the final regulations permit suspended section 987 loss to be recognized to the extent of section 987 gain recognized in connection with a transaction described in §1.987-13(f) or (g). Because those transactions generally would be treated as terminations under §1.987-8, any net unrecognized section 987 gain of the owner will be recognized immediately before the transaction and will be taken into account under the loss-to-the-extent-of-gain rule.

C. *Clarification of §1.987-13*

A comment requested clarification as to the mechanics for recognizing suspended section 987 loss following a transaction described in §1.987-13(e), in which an original suspended loss QBU owner is transferred outside the controlled group. The comment also suggested clarifying the interaction between the successor rules of §1.987-13(b) and (c) and the inbound transaction rule in proposed §1.987-13(g).

The final regulations clarify that, following a transaction described in §1.987-13(e) (in which the original suspended loss QBU owner is transferred outside the controlled group), the original owner recognizes suspended section 987 loss to the extent that it recognizes section 987 gain in the same recognition grouping. Further, in the case of a transaction described in §1.987-13(e) (transfer of original suspended loss QBU owner), §1.987-13(f) (section 331 liquidation), or §1.987-13(g) (inbound transaction), suspended section 987 loss is not recognized or attributed to a successor suspended loss QBU under §1.987-13(b) or (c). The final regulations also clarify that the rules of §1.987-13(f) apply to a transaction (such as a section 331 liquidation) in which the owner of a section 987 QBU ceases to exist without having a successor (that is, this rule applies even if the section 987 QBU with respect to which the suspended section 987 loss arose had not previously been terminated, such that the owner was not an original suspended loss QBU owner).

XII. Comments and Changes to Proposed §1.987-14: Applicability Date

Proposed §1.987-14 would provide rules relating to the applicability date of the section 987 regulations.

In general, the 2023 proposed regulations are proposed to apply to taxable years beginning after December 31, 2024. Proposed §1.987-14(a)(1). In the case of a terminating QBU (that is, a section 987 QBU that terminates after November 9, 2023, but before the section 987 regulations are generally applicable), the 2023 proposed regulations, as finalized, generally would apply immediately before the termination.

A comment requested that the general applicability date be delayed until taxable years beginning after December 31, 2025, to allow additional time for taxpayers to build systems and processes to comply with the final regulations. Another comment requested a deferred applicability date no earlier than the taxable year beginning on or after one year after the first day of the first taxable year following the date on which the final regulations are published.

One comment requested that the special rule for terminating QBUs be eliminated. The comment asserted that the existing deferral rules under §1.987-12 are sufficient to prevent abuse.

Under §1.987-15, the final regulations generally apply to taxable years beginning after December 31, 2024, consistent with the 2023 proposed regulations. *See* §1.987-15(a)(1). *See also* §§1.861-9(g)(2)(v), 1.985-5(g), 1.988-1(i), 1.988-4(b)(2)(ii), 1.989(a)-1(b)(4) and (d)(4), and 1.1502-13(l)(10). The 2016 final regulations originally were applicable to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016 (thus, they would have been applicable in 2018 for calendar year taxpayers). Although the applicability date of those regulations was subsequently deferred, taxpayers have been on notice for many years concerning the general framework of the section 987 regulations. Final regulations are necessary to provide guidance to taxpayers regarding the proper determination of section 987 taxable income or loss and section 987 gain or loss and to provide a consistent set of rules applicable to all taxpayers. Accordingly, further deferral would not serve the interest of sound tax administration. The applicability date under §1.987-15(a)(1) is consistent with the rule under section 7805(b) of the Code regarding retroactivity of regulations or rulings.

In addition, the final regulations retain the special applicability date providing that the section 987 regulations apply to terminating QBUs immediately before the termination. *See* §1.987-15(a)(2). This rule is needed to prevent taxpayers from terminating a section 987 QBU before the section 987 regulations generally become applicable in order to avoid the rules of the section 987 regulations, including the loss suspension rules in §§1.987-10, 1.987-11, and 1.987-13.

XIII. Comments and Changes to Proposed §1.1502-13: Intercompany Transactions

The 2023 proposed regulations would provide a new rule applicable to certain intercompany transactions (as defined in §1.1502-13(b)(1)(i)) involving section 987 QBUs. *See* proposed §1.1502-13(j)(9).

In general, §1.1502-13 provides rules to clearly reflect the taxable income and tax liability of a consolidated group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or consolidated tax liability. *See* §1.1502-13(a). Under §1.1502-13, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The matching rule in §1.1502-13(c) is one of the principal rules in §1.1502-13 that produces the effect of transactions between divisions of a single corporation (single entity treatment). *See* §1.1502-13(a)(6)(i).

To address potential mismatches that make it difficult to apply the rules of §1.1502-13 to section 987 QBUs, the 2023 proposed regulations would apply a reattribution rule that treats all intercompany transactions involving a section 987 QBU as attributable to a member's home office rather than to any section 987 QBU. As a result, an intercompany transaction between one member of a consolidated group and a section 987 QBU of another member of the same group is treated as a combination of (i) an intercompany transaction between the consolidated group members (that is, S and B), and (ii) transfers between the section 987 QBU and its owner as necessary to account for the effect of the transaction on the assets and liabilities of the section 987 QBU. This approach would ensure that consolidated taxable income includes the same amount of section 987 gain or loss as would be recognized if the members were divisions of a single corporation.

One comment requested that the proposed rule be removed, on the grounds that it would change the amount of currency gain or loss recognized by S and B with respect to intercompany transactions. For example, assume that S has a section 987 QBU with the euro as its functional currency, and the QBU makes a euro-denominated loan to B. The comment noted that, under the proposed rule, B's foreign currency exposure and S's foreign currency exposure offset for Federal income tax purposes (that is, if B recognizes any section 988 gain or loss on the interest payments, S will recognize an offsetting amount of section 988 loss or gain). The comment indicated that, for financial accounting purposes, B's foreign currency exposure would result in net income (it would not be offset by S's foreign currency exposure). According to the comment, B would typically enter into a separate hedging transaction (for example, a foreign currency forward contract) to hedge this exposure. However, under the proposed rule, because the section 988 gain or loss of B and S with respect to the loan will offset for tax purposes, the hedging transaction itself will generate net section 988 gain or loss. Therefore, the comment asserted that the proposed rule may have the practical effect of giving rise to income or loss for tax purposes for consolidated groups with respect to hedging transactions.

In other words, under the view expressed in the comment, if the taxpayer enters into a hedging transaction for U.S. GAAP purposes, B would have section 988 gain or loss on the loan absent the proposed rule, and such gain or loss would be offset by loss or gain on the hedging transaction; in contrast, under the proposed rule, B's section 988 gain or loss on the loan would be offset by S's section 988 loss or gain, and loss or gain on the hedging transaction would not be offset.

The comment appears to reflect the view that, in the absence of the reattribution rule in proposed §1.1502-13(j)(9), the matching rule of §1.1502-13(c) does not apply to transactions involving section 987 QBUs, and as a result the tax treatment of S and B is determined independently. Therefore, the comment appears to assume that the Federal income tax treatment and the accounting treatment of transactions involving section 987 QBUs would be identical without the proposed rule.

The Treasury Department and the IRS disagree with the comment. The intercompany transaction rules in §1.1502-13 apply to all intercompany transactions, including those that involve section 987 QBUs, and taxpayers must apply those rules to achieve single entity treatment. The reattribution rule of proposed §1.1502-13(j)(9) merely reflects the application of the intercompany transaction rules to section 987 QBUs in a simpler and more administrable manner for taxpayers and the IRS. Therefore, removing the reattribution rule would not address the concerns expressed in the comment. Additionally, the approach discussed in the comment would be fundamentally inconsistent with the purposes of section 1502 and §1.1502-13: it would not clearly reflect the income tax liability of the consolidated group, because it would allow intercompany transactions to accelerate or defer currency gains and losses. The proposed reattribution rule is therefore finalized without change.

Comments also requested clarification regarding Example 8 in proposed §1.1502-13(j)(10)(viii). In response, the final regulations include additional facts in Example 8 as well as two alternative fact patterns involving (i) a member's disposition of an intercompany loan before its satisfaction, and (ii) a member ceasing to be a member of the consolidated group while an intercompany loan remains outstanding. The final regulations also include formatting changes to the examples under §1.1502-13(j) that were proposed in REG-134420-10 (88 FR 52057).

XIV. Other Comments and Revisions

A comment recommended that the Treasury Department and the IRS consider the impact of section 987 gain or loss on the corporate alternative minimum tax ("CAMT") regime. The comment did not recommend specific rules to be implemented for this purpose. The final regulations do not address the application of the CAMT regime. Accordingly, this comment was not adopted because it is outside the scope of the final regulations.

Similarly, comments requested that information relating to section 987 should continue to be reported on Form 8858, Schedule C-1, with modifications for taxpayers that do not make a current rate election. The development or modification of forms related to section 987 is outside the scope of the final regulations. Therefore, this comment was not adopted.

A comment was received in response to the 2016 proposed regulations during the initial comment period for those proposed regulations. The comment requested that the 2016 final regulations and the 2016 temporary regulations be reproposed with a deferred applicability date, which is consistent with the approach taken by the 2023 proposed regulations and these final regulations.

In addition to the provisions described in parts I through XIII of this Summary of Comments and Explanation of Revisions, the final regulations include other wording changes, additions, deletions, and organizational changes to the 2023 proposed regulations for purposes of clarification. For example, the rules in §1.987-3(c)(3) relating to the adjustments required under the simplified inventory method have been clarified, and an example has been added to illustrate those rules. Similarly, the rules of §1.985-5 have been modified to update cross-references to the section 987 regulations and to clarify the example in §1.985-5(f).

Special Analyses

I. *Regulatory Planning and Review–Economic Analysis*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) (PRA) requires that a Federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. 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 OMB.

The collections of information in the final regulations with respect to section 987 are in §§1.987-1(g), 1.987-9, 1.987-10(k), and 1.987-14(c). The likely respondents are individuals who file a Form 1040 and businesses that file a Form 1065 or Form 1120. The final regulations do not apply to trusts and estates. *See* part II.A.2 of the Summary of Comments and Explanation of Revisions.

The collection of information provided by §1.987-1(g) is required only when a taxpayer makes or revokes certain elections for purposes of calculating its section 987 taxable income or loss and section 987 gain or loss with respect to a section 987 QBU. In the first year in which the section 987 regulations apply to the taxpayer, or the taxpayer or a member of its consolidated group or section 987 electing group is the owner of a section 987 QBU, the taxpayer may make any section 987 election. Thereafter, the taxpayer may make or revoke a current rate election, annual recognition election, or section 988 mark-to-market election only every five years and may make or revoke other elections only with the consent of the Commissioner, which may be granted with a private letter ruling. When a taxpayer makes or revokes an election, the collection of information is mandatory. The collection of information required by §1.987-1(g) will be used by the IRS for tax compliance purposes.

Section 1.987-9 is intended to specify how a taxpayer satisfies its recordkeeping obligations under section 6001 with respect to section 987. The recordkeeping requirements under §1.987-9 are considered general tax records under §1.6001-1(e). For PRA purposes, general tax records are already approved by OMB under 1545-0074 for individuals and under 1545-0123 for business entities. The IRS intends that the information collection requirements pursuant to §1.987-9 will be satisfied by the taxpayer maintaining permanent books and records that are adequate to verify its section 987 gain or loss and section 987 taxable income or loss with respect to its section 987 QBU.

Specifically, with respect to each section 987 QBU, successor deferral QBU, and successor suspended loss QBU for a taxable year, as applicable, §1.987-9 requires taxpayers to maintain books and records related to the amount of the items of income, gain, deduction, or loss attributed to the section 987 QBU in the functional currency of the section 987 QBU and its owner; the adjusted balance sheet of the section 987 QBU in the functional currency of the section 987 QBU and its owner (or the information used to determine QBU net value under §1.987-4(e)(2)(iii), as explained in part V.A.1 of the Summary of Comments and Explanation of Revisions); the exchange rates used to translate items of income, gain, deduction, or loss of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which the convention is determined; the exchange rates used to translate the assets and liabilities of the section 987 QBU into the owner's functional currency and, if a spot rate convention is used, the manner in which the convention is determined; the amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner and the section 987 QBU; the amount of the unrecognized section 987 gain or loss for the taxable year; the amount of the net accumulated unrecognized section 987 gain or loss for the taxable year; the amount of the remittance and the remittance proportion for the taxable year; the computations required under §§1.861-9(g) and 1.861-9T(g) for purposes of sourcing and characterizing section 987 gain or loss, deferred section 987 gain or loss, or suspended section 987 loss under §1.987-6; the cumulative suspended section 987 loss in each recognition grouping; the outstanding deferred section 987 gain or loss in each recognition grouping; the transition information required to be determined under §1.987-10(k); and the identification required under §1.987-14(c) with respect to a section 987 hedging transaction. These records are required for the IRS to validate that section 987 gain or loss and section 987 taxable income or loss have been properly determined.

The Treasury Department and the IRS are adding a recordkeeping requirement under §1.987-14(c) based on a public comment on the substantive rules of the 2023 proposed regulations which requested implementation of a section 987 hedging election. *See* part V.B.1 of the Summary of Comments and Explanation of Revisions. Under §1.987-14(c), the final regulations require an identification statement to be kept in the taxpayers' books and records with respect to a section 987 hedging transaction described in §1.987-14(b)(1).

The collection of information in §1.987-10(k) is mandatory. Specifically, §1.987-10(k) would require a taxpayer to file a "Section 987 Transition Information" statement with its return for the taxable year beginning on the transition date (as defined in §1.987-10(c)). The statement would contain information that is necessary for a taxpayer to transition to the final section 987 regulations. Specifically, the statement requires a taxpayer to provide information that is relevant to determining the taxpayer's pretransition gain or loss with respect to its section 987 QBUs. The collection of information required by §1.987-10(k) will be used by the IRS for tax compliance purposes.

The Treasury Department and the IRS intend that the information described in §1.987-1(g) will be collected by attaching a statement to a taxpayer's return (such as the appropriate Form 1040, Form 1120, Form 1065, or other appropriate form). With respect to §1.987-10(k), the IRS also intends that the collection of information will be conducted by attaching a "Section 987 Transition Information" statement to a return. For purposes of the PRA, the reporting burden associated with those collections of information with respect to §§1.987-1(g) and 1.987-10(k) will be reflected in the PRA submissions associated with those forms. The OMB Control Numbers for the forms will be approved under 1545–0074 for individuals and under 1545–0123 for business entities.

To the extent that a taxpayer makes or revokes an election by obtaining a private letter ruling, the reporting burden associated with those collections of information will be reflected in the PRA submissions associated with revenue procedures governing private letter rulings. The OMB Control Number for the collection of information for those revenue procedures is control number 1545-1522. The final regulations would only require taxpayers to follow the procedures under Revenue Procedure 2024-1, IRB 2024-1 (or future revenue procedure governing private letter rulings) and would not change the collection requirements of the Revenue Procedure.

The attachment to a return used for making elections with respect to these final regulations will be used by those taxpayers making or revoking an election for the taxable year. The "Section 987 Transition Information" statement attached to a return will be used by all taxpayers, but generally only with respect to the taxable year in which the taxpayer transitions to these final regulations. In certain cases, if the taxpayer owns a QBU that terminates after November 9, 2023, and before the taxable year in which the taxpayer transitions to the final regulations, the "Section 987 Transition Information" statement must be filed for that taxable year too, but the statement would only contain information with respect to the terminating QBU. The burden will be accounted for in 1545-0074 for individuals and in 1545-0123 for businesses.

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

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this rulemaking will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. The final regulations affect taxpayers with foreign branch operations and taxpayers that own an interest in a foreign partnership (or a partnership with a foreign branch).

The number of small entities potentially affected by the final regulations is unknown; however, it is unlikely to be a substantial number because taxpayers with wholly owned foreign operations are typically larger businesses. The Treasury Department and the IRS estimate that the total number of corporations (other than S corporations) with a foreign branch subject to section 987 is approximately 2,000. This estimate is based on the number of corporations (other than S corporations) that filed a Form 8858 in 2022 that showed that the filer: (1) owned at least one disregarded entity or branch with a functional currency different from the functional currency of the owner, and (2) indicated that the disregarded entity or branch was a section 989 QBU. As shown in the following table, only a small percentage of those filers are small entities.

Total Receipts/Positive Income (2022)	Percentage of Filers
Under $5 Million	7%
$5 Million to $10 Million	2%
$10 Million to $25 Million	4%
Over $25 Million	87%

The number of affected corporations (other than S corporations) with total receipts of less than $25 million represents 0.02% of all corporations (other than S corporations) with total receipts of less than $25 million.

The Treasury Department and the IRS estimate that the total number of partnerships and S corporations with a foreign branch subject to section 987 is approximately 800. Approximately 50 percent of those filers have gross receipts of less than $25 million, but the data does not indicate whether these partnerships are part of larger enterprises. The number of affected partnerships and S corporations with total receipts of less than $25 million represents 0.004% of all partnerships and S corporations with total receipts of less than $25 million. Small entities may also own partnership interests.

The primary rules that apply to partnerships (that is, the deferral rules in §1.987-12 and the suspended loss rules in §§1.987-11 and 1.987-13) apply only in the case of a remittance or termination that would result in the recognition of a significant amount of section 987 gain or loss. Small entities typically will not recognize section 987 gain or loss in excess of the applicable thresholds.

These final regulations generally modify the rules that would otherwise apply under the 2016 final regulations by providing taxpayers with additional elections that reduce the compliance burden of applying section 987. Small entities generally would not be affected by these rules unless they choose to make one of the new elections in order to reduce their compliance burden. In addition, the final regulations contain several rules intended to limit their impact on small taxpayers. For example, the final regulations provide a de minimis rule under which section 987 loss is not suspended unless the amount of the loss exceeds the lesser of $3 million or two percent of gross income, as described in part X.A.1 of the Summary of Comments and Explanation of Revisions. In addition, for purposes of the transition rules, the final regulations provide an election under which small businesses can treat small QBUs as having no pretransition gain or loss. *See* part IX.A.2 of the Summary of Comments and Explanation of Revisions.

A portion of the economic impact of the final regulations may derive from the collection of information requirements imposed under §§1.987-1(g), 1.987-10(k), and 1.987-14(c). The Treasury Department and the IRS have determined that the average burden is 1.95 hours per response. The IRS's Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is $99.87

per hour. Thus, the annual burden per taxpayer from each collection of information requirement is $194.75. The requirements of §1.987-1(g) apply only if a taxpayer chooses to make or revoke an election (and only in the year of the election or revocation), the requirements of §1.987-10(k) apply only in the first taxable year in which the final regulations apply, and the requirements of §1.987-14(c) apply only if a taxpayer identifies a hedge as a section 987 hedging transaction (which is unlikely to be relevant for small entities).

Another portion of the economic impact of the final regulations may derive from the recordkeeping requirements of §1.987-9, which identify the records needed to satisfy the taxpayer's obligations under section 6001. The requirements of §1.987-9 generally will be less burdensome for small entities than the requirements of the 2016 final regulations due to the modifications described in part V.A.1 of the Summary of Comments and Explanation of Revisions (which permit QBU net value to be computed without preparing a tax basis balance sheet).

IV. *Section 7805(f)*

Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business and no comments were received.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The final regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The final regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin or Cumulative Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

Drafting Information

The principal authors of these final regulations are Adam G. Province and Raphael J. Cohen of the Office of Associate Chief Counsel (International); and Matthew N. Palucki and Jeremy Aron-Dine of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by:

a. Removing the entry for §§1.861-9 and 1.861-9T and §§1.861-8T through 1.861-14T;

b. Adding entries for §§1.861-8T, 1.861-9, 1.861-9T through 1.861-14T in numerical order;

c. Removing the entry for §§1.985-0 through 1.985-5;

d. Adding entries for §§1.985-0 through 1.985-5 in numerical order;

e. Removing the entry for §§1.987-1 through 1.987-5;

f. Adding entries for §§1.987-1 through 1.987-11 in numerical order;

g. Revising the entry for §1.987-12;

h. Adding entries for §§1.987-13 through 1.987-15 in numerical order;

i. Removing the entry for §§1.988-0 through 1.988-5;

j. Adding entries for §§1.988-0 through 1.988-5 and 1.989(a)-1 in numerical order; and

k. Revising the entry for §1.1502-13.

The additions and revisions read as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.861-8T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

Section 1.861-9 also issued under 26 U.S.C. 861, 863(a), 864(e), 864(e)(7), 865(i), 987, and 989(c), and 7701(f).

Section 1.861-9T also issued under 26 U.S.C. 861, 863(a), 864(e), 864(e)(7), 865(i), and 7701(f).

* * * * *

Section 1.861-10T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

* * * * *

Section 1.861-11T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

* * * * *

Section 1.861-12T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

* * * * *

Section 1.861-13T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

* * * * *

Section 1.861-14T also issued under 26 U.S.C. 863(a), 864(e), 865(i), and 7701(f).

* * * * *

Section 1.985-0 also issued under 26 U.S.C. 985.

Section 1.985-1 also issued under 26 U.S.C. 985.
Section 1.985-2 also issued under 26 U.S.C. 985.
Section 1.985-3 also issued under 26 U.S.C. 985.
Section 1.985-4 also issued under 26 U.S.C. 985.
Section 1.985-5 also issued under 26 U.S.C. 985, 987, and 989.
* * * * *
Section 1.987-1 also issued under 26 U.S.C. 987, 989, and 1502.
Section 1.987-2 also issued under 26 U.S.C. 987, 989, and 1502.
Section 1.987-3 also issued under 26 U.S.C. 987 and 989.
Section 1.987-4 also issued under 26 U.S.C. 987 and 989.
Section 1.987-5 also issued under 26 U.S.C. 987 and 989.
Section 1.987-6 also issued under 26 U.S.C. 904, 987, and 989.
Section 1.987-7 also issued under 26 U.S.C. 987 and 989.
Section 1.987-8 also issued under 26 U.S.C. 987 and 989.
Section 1.987-9 also issued under 26 U.S.C. 987, 989, and 6001.
Section 1.987-10 also issued under 26 U.S.C. 987, 989, and 6001.
Section 1.987-11 also issued under 26 U.S.C. 987, 989, and 1502.
Section 1.987-12 also issued under 26 U.S.C. 987 and 989.
Section 1.987-13 also issued under 26 U.S.C. 987 and 989.
Section 1.987-14 also issued under 26 U.S.C. 987 and 989.
Section 1.987-15 also issued under 26 U.S.C. 987 and 989.
Section 1.988-0 also issued under 26 U.S.C. 988.
Section 1.988-1 also issued under 26 U.S.C. 988 and 989.
Section 1.988-2 also issued under 26 U.S.C. 988.
Section 1.988-3 also issued under 26 U.S.C. 988.
Section 1.988-4 also issued under 26 U.S.C. 988 and 989.
Section 1.988-5 also issued under 26 U.S.C. 988.
* * * * *
Section 1.989(a)-1 also issued under 26 U.S.C. 989.
* * * * *
Section 1.1502-13 also issued under 26 U.S.C. 250(c), 987, 989, and 1502.
* * * * *

Par. 2. Section 1.861-9 is amended by:

a. Revising paragraphs (g)(2)(ii)(A) introductory text, (g)(2)(ii)(A)(*1*), and (g)(2)(ii)(B); and

b. Adding paragraph (g)(2)(v).

The revisions and addition read as follows:

§1.861-9 Allocation and apportionment of interest expense and rules for asset-based apportionment.

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(A) *Tax book value method*. In the case of taxpayers using the tax book value method of apportionment, the following rules apply to determine the value of the assets of a qualified business unit (QBU) (as defined in section 989(a)) of a domestic corporation with a functional currency other than the dollar.

(*1*) *Section 987 QBU*. In the case of a section 987 QBU (as defined in §1.987-1(b)(3)), the tax book value is determined by applying the rules of paragraph (g)(2)(i) of this section and §1.861-9T(g)(3) to the beginning-of-year and end-of-year owner functional currency amount of assets. The beginning-of-year owner functional currency amount of assets is determined by reference to the owner 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 owner functional currency amount of assets is determined by reference to the owner 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 owner functional currency amount of assets, as so determined within each grouping, are then averaged as provided in paragraph (g)(2)(i) of this section.
* * * * *

(B) *Fair market value method.* In the case of taxpayers using the fair market value method of apportionment, the beginning-of-year and end-of-year fair market values of branch assets within each grouping are computed in dollars and averaged as provided in this paragraph (g)(2) and §1.861-9T(g)(2).
* * * * *

(v) *Applicability date*. Generally, paragraph (g)(2)(ii)(A)(*1*) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-15(b), a taxpayer chooses to apply §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then paragraph (g)(2)(ii)(A)(*1*) of this section applies to that taxable year and subsequent years.
* * * * *

§1.861-9T [Amended]

Par. 3. Section 1.861-9T is amended by removing and reserving paragraph (g)(2)(ii) and removing paragraph (g)(2)(vi).

Par. 4. Section 1.904-4 is amended by revising paragraph (c)(5)(iii)(B) to read as follows:

§1.904-4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(c) * * *

(5) * * *

(iii) * * *

(B) *Section 987*. For special rules relating to the allocation and apportionment of foreign income taxes to section 987 items, *see* §1.987-6(b)(3).
* * * * *

Par. 5. Add an undesignated center heading before § 1.985-0 to read as follows:
*****

Foreign Currency Transactions

*****

§1.985-1 [Amended]

Par. 6. Section 1.985-1 is amended by:

a. In paragraph (f) designating *Examples 1* through *12* as paragraphs (f)(1) through (12), respectively; and

b. Removing and reserving newly redesignated paragraphs (f)(9) through (11).

Par. 7. Section 1.985-5 is amended by:

a. In paragraph (a) removing the language "§1.987-1(b)(2)" and adding the language "§1.987-1(b)(3)" in its place;

b. In paragraph (d)(1)(i) removing the language "1.987-11" and adding the language "1.987-15" in its place;

c. Revising the last sentence of paragraph (d)(2);

d. Removing the second sentence of paragraph (e)(1);

e. Revising and republishing paragraphs (e)(4) and (f); and

f. Revising paragraph (g).

The revisions read as follows:

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

* * * * *

(d) * * *

(2) * * * *See* §§1.987-5, 1.987-8, 1.987-12, and 1.987-13 for the effect of a termination of a section 987 QBU that is subject to §§1.987-1 through 1.987-15.

(e) * * *

(4) *Adjustments to a section 987 QBU's balance sheet and unrecognized section 987 gain or loss when an owner changes functional currency*—(i) *Owner changing to a functional currency other than the section 987 QBU's functional currency.* If an owner of a section 987 QBU, subject to §§1.987-1 through 1.987-15 pursuant to §1.987-1(b)(1), changes to a functional currency other than the functional currency of the section 987 QBU, the adjustments described in paragraphs (e)(4)(i)(A) through (C) of this section are taken into account for purposes of section 987.

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

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

(C) *Translation of unrecognized section 987 gain or loss.* Any net accumulated unrecognized section 987 gain or loss determined under § 1.987-4(c), cumulative suspended section 987 loss determined under §1.987-11(b), or deferred section 987 gain or loss determined under §1.987-12 is translated from the owner's old functional currency into the owner's new functional currency using the spot rate for translating an amount denominated in the owner's old functional currency into the owner's new functional currency on the last day of the last taxable year ending before the year of change.

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

(iii) *Owner changing to the same functional currency as the section 987 QBU.* If an owner changes its functional currency to the functional currency of its section 987 QBU, the section 987 QBU is treated as if it terminated on the last day of the last taxable year ending before the year of change. See §§1.987-5, 1.987-8, 1.987-12, and 1.987-13 for the consequences of a termination of a section 987 QBU that is subject to §§1.987-1 through 1.987-15.

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

(1) *Facts*. FC, a foreign corporation, is wholly owned by DC, a domestic corporation. The Commissioner granted permission to change FC's functional currency from the British pound to the euro beginning January 1, year 2. The EUR/GBP exchange rate on December 31, year 1, is €1:£0.50.

(2) *Analysis*—(i) *Determining new functional currency basis of property and liabilities*. The following table shows how FC must convert the items on its balance sheet from the British pound to the euro on December 31, year 1.

Table 1 to paragraph (f)(2)(i)
Conversion of FC's Balance Sheet Items

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

(ii) *Exchange gain or loss on section 988 transactions*. Under paragraph (b) of this section, FC will recognize a £50,000 loss (£50,000 current value minus £100,000 historical basis) on the Euro Bond resulting from the change in functional currency because, after the change, the Euro Bond will no longer be an asset denominated in a non-functional currency. The amount of FC's retained earnings on its December 31, year 1, balance sheet reflects the £50,000 loss on the Euro Bond.

(g) *Applicability date*. Generally, this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-15(b), a taxpayer chooses to apply §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then this section applies to that taxable year and subsequent years.

Par. 8. Revise §§ 1.987-0 through 1.987-12 and add §§ 1.987.13 through 1.987-15 to read as follows:

Foreign Currency Transactions

*****

Sec.

*****

§1.987-0 Table of contents.

This section lists the headings for §§1.987-1 through 1.987-15.

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

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(6) Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.

(7) Step 7: Increase the amount determined in steps 1 through 6 by certain expenses or losses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.

(8) Step 8: Decrease the amount determined in steps 1 through 7 by the amount of certain income or gain that is not included in taxable income in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.

(9) Step 9: Increase or decrease the amount determined in steps 1 through 8 by any income or gain, or any deduction or loss, respectively, that does not impact the adjusted balance sheet.

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(5) Section 987 QBU ceases to be an eligible QBU with a functional currency different from its owner.
(6) Change in form of ownership.
(c) Transactions described in section 381(a).
(1) Liquidations.
(2) Reorganizations.
(d) [Reserved]
(e) Effect of terminations.
(f) Examples.
(1) Example 1: Cessation of operations.
(i) Facts.
(ii) Analysis.
(2) Example 2: Transfer of a section 987 QBU to a member of a consolidated group.
(i) Facts.
(ii) Analysis.
(3) Example 3: Cessation of controlled foreign corporation status.
(i) Facts.
(ii) Analysis.
(4) Example 4: Section 332 liquidation.
(i) Facts.
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(5) [Reserved]
(6) Example 6: Deemed transfers to a CFC upon a check-the-box election.
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§1.987-9 Recordkeeping requirements.

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

§1.987-10 Transition rules.

(a) Overview.
(1) In general.
(2) Terms defined under prior §1.987-12.
(b) Scope.
(1) Owner of a section 987 QBU.
(2) Deferral QBU owner and owner of outbound loss QBU.
(c) Transition date.
(1) In general.
(2) Terminating QBU.
(i) In general.
(ii) Ordering rule.
(d) Application of the section 987 regulations after the transition date.
(1) Owner functional currency net value on the last day of the preceding taxable year.
(2) Determination of historic rate.
(3) Transition exchange rate.
(i) In general.
(ii) Earnings only method.
(e) Pretransition gain or loss.
(1) In general.
(2) Amount of pretransition gain or loss for an owner that applied an eligible pretransition method.
(i) Owner of a section 987 QBU
(ii) Deferral QBU owner.
(iii) Owner of an outbound loss QBU.
(3) Amount of pretransition gain or loss for an owner that did not apply an eligible pretransition method.
(i) In general.
(ii) Computation of pretransition gain or loss.
(iii) Annual unrecognized section 987 gain or loss.
(iv) Deferral QBU owner.
(v) Owner of an outbound loss QBU.
(4) Eligible pretransition method.
(i) Earnings and capital method.
(ii) Other reasonable methods.
(iii) Other earnings only methods.
(iv) Error in the application of a section 987 method.
(v) Certain consistent practices not treated as errors.
(vi) Deferral of section 987 gain or loss until termination is not reasonable.
(vii) Anti-abuse rule.
(5) Recognition of pretransition gain or loss.
(i) In general.
(ii) Election to recognize pretransition section 987 gain or loss ratably over the transition period.
(6) Predecessor of an owner.
(i) In general.
(ii) Predecessor.
(7) Small business election.
(i) Scope.
(ii) Owner threshold.
(iii) QBU threshold.
(iv) Small business election.
(f) QBUs to which the fresh start transition method was applied.
(1) In general.
(2) Application of the section 987 regulations after the transition date.
(i) Owner functional currency net value on the last day of the preceding taxable year.
(ii) Determination of historic rate.
(iii) Unrecognized section 987 gain or loss.
(3) Taxpayers that are required to transition using the fresh start transition method.
(g) [Reserved]
(h) Determination of source and character.
(1) In general.
(2) Deferral QBU or outbound loss QBU.
(i) [Reserved]
(j) Adjustments to avoid double counting or omissions.
(k) Reporting.
(1) In general.
(2) QBUs for which reporting is required.
(i) In general.
(ii) QBUs to which the fresh start transition method was applied.
(3) Attachments not required where information is reported on a form.
(4) No change in method of accounting.
(l) Examples.
(1) Example 1: Earnings and capital method.
(i) Facts.
(ii) Analysis.
(2) Example 2: Earnings only method described in paragraph (e)(4)(ii) of this section.
(i) Facts.
(ii) Analysis.
(3) Example 3: Earnings only method described in paragraph (e)(4)(iii) of this section.
(i) Facts.
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(i) Facts.
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(i) Facts.
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§1.987-11 Suspended section 987 loss relating to certain elections; loss to the extent of gain rule.

(a) In general.
(b) Cumulative suspended section 987 loss in a recognition grouping.
(1) In general.
(2) Combined QBU.
(3) Separated QBU.
(c) Suspension of section 987 loss for taxable years in which a current rate election is in effect and an annual recognition election is not in effect.
(1) In general.
(2) De minimis rule.
(3) Taxable year of controlled group members.
(i) In general.
(ii) Owner is a CFC.
(d) Suspension of net unrecognized section 987 loss upon making or revoking certain elections.
(1) Making an annual recognition election.
(2) Revoking a current rate election.
(e) Loss-to-the-extent of gain rule.
(1) In general.
(2) Separate determination for each recognition grouping.
(3) Amount of suspended section 987 loss recognized.
(i) Current year gain amount.

(ii) Lookback gain amount.
(iii) Suspended section 987 loss not taken into account.
(iv) Lookback period.
(v) Anti-abuse rule.
(4) Suspended section 987 loss recognized with respect to each section 987 QBU and suspended section 987 loss QBU.
(5) Section 381(a) transactions.
(i) In general.
(ii) Limitation for inbound section 381(a) transactions.
(6) Consolidated group members.
(i) In general.
(ii) Suspended section 987 losses arising in separate return limitation years.
(f) Recognition groupings.
(1) Sourcing and section 904 category.
(2) Statutory and residual groupings for CFC owners.
(g) Examples.
(1) Example 1: Suspension of section 987 loss and recognition of suspended section 987 loss.
(i) Facts.
(ii) Analysis.
(2) Example 2: Recognition of suspended section 987 loss by reason of gain recognized during the lookback period.
(i) Facts.
(ii) Analysis.
(iii) Alternative facts.
(iv) Analysis of alternative facts.
(3) Example 3: Suspension of section 987 loss when a current rate election is revoked. (i) Facts.
(ii) Analysis.

§1.987-12 Deferral of section 987 gain or loss.

(a) Overview.
(1) Scope.
(2) Exceptions.
(i) Annual recognition election.
(ii) De minimis rule.
(b) Treatment of section 987 gain and loss in connection with a deferral event.
(1) Gain or loss recognized (or suspended) in the taxable year of a deferral event.
(2) Deferred section 987 gain or loss.
(i) In general.
(ii) Deferred section 987 gain or loss attributable to a successor deferral QBU.
(c) Recognition (or suspension) of deferred section 987 gain or loss following a deferral event.
(1) Recognition upon a subsequent remittance.
(i) In general.
(ii) Amount.
(iii) Deemed remittance by a successor deferral QBU.
(2) Deferral events and outbound loss events with respect to a successor deferral QBU.
(d) Successor deferral QBU becomes a successor suspended loss QBU.
(e) Anti-abuse rule.
(f) Combinations and separations of successor deferral QBUs.
(1) Combined QBU.
(2) Separated QBU.
(g) Definitions.
(1) Deferral event.
(i) Events.
(ii) Assets on books of successor deferral QBU.
(2) Successor deferral QBU.
(3) Original deferral QBU owner.
(4) Qualified successor.
(h) Examples.
(1) Example 1: Contribution of a section 987 QBU with net unrecognized section 987 gain to a member of the controlled group.
(i) Facts.
(ii) Analysis.
(2) Example 2: Contribution of a section 987 QBU with net unrecognized section 987 loss to a member of the controlled group when a current rate election is in effect.
(i) Facts.
(ii) Analysis.
(3) Example 3: Election to be classified as a corporation.
(i) Facts.
(ii) Analysis.
(4) Example 4: Partial recognition of deferred gain or loss.
(i) Facts.
(ii) Analysis.

§1.987-13 Suspended section 987 loss upon terminations.

(a) Overview.
(1) In general.
(2) Ordering rule.
(b) Termination of a section 987 QBU with suspended loss.
(1) Suspended section 987 loss becomes suspended section 987 loss with respect to a successor suspended loss QBU.
(i) Successor suspended loss QBU.
(ii) Attribution of suspended section 987 loss to successor suspended loss QBU.
(2) Recognition of suspended section 987 loss.
(c) Termination of a successor suspended loss QBU.
(1) Successor to the successor suspended loss QBU.
(i) Successor suspended loss QBU.
(ii) Attribution of suspended section 987 loss to successor suspended loss QBU.
(2) Recognition of suspended section 987 loss.
(d) Transfer of successor suspended loss QBU owner.
(e) Transfer of original suspended loss QBU owner.
(f) Owner ceases to exist.
(g) Inbound nonrecognition transactions–no carryover of suspended section 987 loss.
(h) Outbound transactions–recognition or suspension of net unrecognized section 987 loss.
(1) In general.
(2) Outbound loss event.
(3) Loss recognition upon an outbound loss event
(4) Loss suspension upon outbound loss event.
(i) [Reserved]
(j) Termination of a successor suspended loss QBU.
(k) Anti-abuse.
(l) Definitions.
(1) Original suspended loss QBU owner.
(i) In general.
(ii) Successors.
(2) Successor suspended loss QBU.
(3) Successor suspended loss QBU owner.
(4) Ownership interests.
(5) Significant portion.
(m) Examples.
(1) Example 1: Trade or business of a section 987 QBU ceases.
(i) Facts.
(ii) Analysis.
(2) Example 2: Trade or business of a section 987 QBU is sold to a third party.
(i) Facts.
(ii) Analysis.
(3) Example 3: Outbound loss event.

(i) Facts.
(ii) Analysis.

§1.987-14 Section 987 hedging transactions.

(a) Overview.
(b) Section 987 hedging transaction.
(1) In general.
(2) Requirements.
(i) Identification.
(ii) Current rate election.
(iii) Mark-to-market method of accounting.
(iv) Treatment under U.S. generally accepted accounting principles.
(v) Hedge entered into by owner of the hedged QBU.
(3) Anti-abuse rule.
(4) Partial termination of a section 987 hedging transaction.
(c) Identification requirements.
(1) In general.
(2) Inadvertent error.
(d) Taxation of section 987 hedging transactions.
(1) Hedging gain or loss with respect to a hedged QBU.
(2) Adjustment to unrecognized section 987 gain or loss for the taxable year.
(i) Hedging loss.
(ii) Hedging gain.
(3) Termination of a hedged QBU.
(e) Examples.
(1) Example 1: Section 987 hedging transaction.
(i) Facts.
(ii) Analysis.
(2) Example 2: Excess hedging gain from a section 987 hedging transaction.
(i) Facts.
(ii) Analysis.

§1.987-15 Applicability date.

(a) Applicability date of section 987 regulations.
(1) In general.
(2) Applicability date for a terminating QBU.
(b) Application of the section 987 regulations to taxable years beginning on or before December 31, 2024, and ending after November 9, 2023.
(c) Application of the 2016 and 2019 section 987 regulations.
(1) In general.
(2) Application to section 987 QBUs not owned on the transition date.
(3) Modifications of defined terms for purposes of this paragraph (c).
(i) Application of §1.987-10 in lieu of prior §1.987-10.
(ii) Partnerships not included in section 987 electing group.
(iii) Transition date.
(d) Prior §1.987-12.

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

(a) *In general*. Sections 1.987-1 through 1.987-15 (the *section 987 regulations*) provide rules for determining the taxable income or loss and earnings and profits of a taxpayer with respect to a qualified business unit (QBU) that is subject to section 987. Further, the section 987 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 the section 987 regulations and provides certain definitions, special rules, and procedures for making elections. Section 1.987-2 provides rules for attributing assets and liabilities and items of income, gain, deduction, and loss to an eligible QBU. It also provides rules regarding the translation of items transferred to a section 987 QBU. Section 1.987-3 provides rules for determining and translating the taxable income or loss of a taxpayer with respect to a section 987 QBU. Section 1.987-4 provides rules for determining net unrecognized section 987 gain or loss. Section 1.987-5 provides rules regarding the recognition of section 987 gain or loss. It also provides rules regarding the translation of items transferred from a section 987 QBU to its owner. Section 1.987-6 provides rules regarding the character and source of section 987 gain or loss. Section 1.987-7 provides rules relating to the application of the section 987 regulations with respect to a partnership or S corporation. 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 rules relating to suspended losses in connection with certain elections and the loss-to-the-extent-of-gain rule. Section 1.987-12 provides rules regarding when section 987 gain or loss is deferred, as well as when such deferred amounts are recognized. Section 1.987-13 provides rules relating to suspended section 987 loss of an owner with respect to a section 987 QBU that terminates. Section 1.987-14 provides rules relating to section 987 hedging transactions. Section 1.987-15 provides the applicability date of the section 987 regulations.

(b) *Scope of section 987 and certain rules relating to QBUs*—(1) *Persons subject to section 987*—(i) *In general*. Except as provided in paragraphs (b)(1)(ii) and (b)(6) of this section, any individual or corporation is subject to the section 987 regulations. *See* §1.987-7 for rules relating to the application of the section 987 regulations in the case of a partnership or S corporation.

(ii) *Inapplicability to certain entities*. Section 987(3) and the section 987 regulations do not apply to individuals who are not United States persons and foreign corporations that either are not controlled foreign corporations or that are controlled foreign corporations in which no United States shareholders own (within the meaning of section 958(a)) stock.

(2) *Application of the section 987 regulations to earnings and profits*—(i) *In general*. The rules and principles of the section 987 regulations also apply to the determination of earnings and profits, and any elections that apply pursuant to the section 987 regulations also apply for purposes of determining earnings and profits.

(ii) *Timing*. Earnings and profits are increased when section 987 gain is recognized and decreased when section 987 loss is recognized. As a result, converting net unrecognized section 987 gain or loss to deferred section 987 gain or loss or suspended section 987 loss does not affect earnings and profits because the amounts have not yet been recognized.

(3) *Definition of a section 987 QBU*—(i) *In general*. For purposes of section 987, a *section 987 QBU* is an eligible QBU that has a functional currency different from its owner. A section 987 QBU will continue to be treated as a section 987 QBU of the owner until a sale or other termination of the section 987 QBU as described in §1.987-8(b) and (c). *See* §1.985-1 for

rules determining the functional currency of an eligible QBU.

(ii) *Section 987 QBU grouping election*—(A) *In general*. Solely for purposes of section 987, an owner may elect to treat all section 987 QBUs with the same functional currency as a single section 987 QBU except to the extent provided in paragraph (b)(3)(ii)(B) of this section. However, a QBU described in §1.987-7(c)(1) may not be treated as part of the same QBU as a section 987 QBU that is not described in §1.987-7(c)(1).

(B) [Reserved]

(4) *Definition of an eligible QBU*—(i) *In general*. For purposes of section 987, an *eligible QBU* means a qualified business unit that is not subject to the United States dollar approximate separate transactions method rules of §1.985-3.

(ii) *Qualified business unit*. For purposes of this paragraph (b)(4), a qualified business unit is defined in §1.989(a)-1(b), except that a corporation, partnership, trust, estate, or disregarded entity is not itself a qualified business unit, but the activities of such entity may be a qualified business unit if they meet the requirements of §1.989(a)-1(b)(1) and (b)(2)(ii). For example, if a corporation is solely engaged in activities that constitute a trade or business, and the corporation maintains only one set of books and records, the activities (but not the corporation) are a qualified business unit.

(5) *Definition of an owner*. For purposes of section 987, an *owner* is any person having direct ownership in an eligible QBU (including ownership through DEs). The term *owner* does not include an eligible QBU. For example, a section 987 QBU (*QBU1*) is not an owner of another section 987 QBU (*QBU2*) even if QBU1 wholly owns the DE that owns QBU2. A person that is not subject to the section 987 regulations under paragraph (b)(1)(ii) of this section can meet the definition of an owner under this paragraph (b)(5) for purposes of applying the section 987 regulations to other persons.

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

(ii) [Reserved]

(6) [Reserved]

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

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

(B) *Analysis*—(*1*) Pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of Business A because it has direct ownership of Business A, an eligible QBU. Because Business A is an eligible QBU with a functional currency that is different from the functional currency of its owner, U.S. Corp, Business A is a section 987 QBU under paragraph (b)(3)(i) of this section. As a result, U.S. Corp and its section 987 QBU, Business A, are subject to section 987.

(*2*) Holding the stock of FC and pounds and servicing a liability does not constitute a trade or business within the meaning of §1.989(a)-1(c). Because the activities of DE1 do not constitute a trade or business within the meaning of §1.989(a)-1(c), such activities are not an eligible QBU. In addition, pursuant to paragraph (b)(4)(ii) of this section, DE1 itself is not an eligible QBU. As a result, neither DE1 nor its activities qualify as a section 987 QBU of U.S. Corp. Therefore, neither the activities of DE1 nor DE1 itself is subject to section 987. For the foreign currency treatment of payments on DE1's pound-denominated liability, *see* §1.988-2(b).

(ii) *Example 2: Owner owns eligible QBUs through DEs*—(A) *Facts*. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and all of the interests in DE2. The only activities of DE1 are Business A activities and holding the interests in DE2. DE2 owns Business B and Business C. For purposes of this example, Business B does not maintain books and records that are separate from 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.

(B) *Analysis*—(*1*) Pursuant to paragraph (b)(4)(ii) of this section, DE1 and DE2 are not eligible QBUs. Moreover, pursuant to paragraph (b)(5) of this section, DE1 is not the owner of the Business A, Business B, or Business C eligible QBUs, and neither Business A nor DE2 is the owner of the Business B or Business C eligible QBUs. Instead, pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of the Business A, Business B, and Business C eligible QBUs.

(*2*) Because Business A and Business B are eligible QBUs with functional currencies that are different than the functional currency of U.S. Corp, Business A and Business B are section 987 QBUs under paragraph (b)(3)(i) of this section.

(*3*) The Business C eligible QBU has the same functional currency as U.S. Corp, the U.S. dollar. Therefore, the Business C eligible QBU is not a section 987 QBU under paragraph (b)(3)(i) of this section.

(iii) *Example 3: Section 987 grouping election*—(A) *Facts*. U.S. Corp owns all of the interests in DE1. DE1 owns Business A and Business B. For purposes of this example, assume Business B has the euro as its functional currency.

(B) *Analysis*—(*1*) Pursuant to paragraph (b)(4)(ii) of this section, DE1 is not an eligible QBU. Moreover, pursuant to paragraph (b)(5) of this section, DE1 is not the owner of the Business A or Business B eligible QBUs. Instead, pursuant to paragraph (b)(5) of this section, U.S. Corp is the owner of the Business A and Business B eligible QBUs.

(*2*) Business A and Business B constitute two separate eligible QBUs, each with the euro as its functional currency. Accordingly, Business A and Business B are section 987 QBUs of U.S. Corp under paragraph (b)(3)(i) of this section. U.S. Corp may elect to treat Business A and Business B as a single section 987 QBU pursuant to paragraph (b)(3)(ii) of this section. If such election is made, pursuant to paragraph (b)(5) of this section, U.S. Corp would be the owner of the Business AB section 987 QBU that would include the activities of both the Business A section 987 QBU and the Business B section 987 QBU. In addition, pursuant to paragraph (b)(5) of this section, DE1 would not be treated as the owner of the Business AB section 987 QBU.

(c) *Exchange rates*. Solely for purposes of section 987, the spot rate, the yearly average exchange rate, and the historic rate are determined as provided in paragraphs (c)(1) through (3) of this section.

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

(ii) *Election to use a spot rate convention*. An owner may elect to use a spot rate convention that reasonably approximates the spot rate determined in paragraph (c)(1)(i) of this section. A spot rate convention may be based on the spot rate at the beginning of a reasonable period, the spot rate at the end of a reasonable period, the average of spot rates for a reasonable period, or spot and forward rates for a reasonable period. For this purpose, a reasonable period may not exceed three months. For example, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate for all transactions during a monthly period may be determined pursuant to one of the following conventions: the spot rate at the beginning of the current month or at the end of the preceding month; the monthly average of daily spot rates for the current or preceding month; or an average of the beginning and ending spot rates for the current or preceding month. Similarly, in lieu of the spot rate determined in paragraph (c)(1)(i) of this section, the spot rate may be determined pursuant to an average of the spot rate and the 30-day forward rate on a day of the preceding month. Use of a spot rate convention that is consistent with the convention used for financial accounting purposes is generally presumed to reasonably approximate the rate in paragraph (c)(1)(i) of this section. However, the Commissioner may prescribe the spot rate as determined in paragraph (c)(1)(i) of this section or an appropriate spot rate pursuant to this paragraph (c)(1)(ii) if the Commissioner determines that the use of the convention would not clearly reflect income based on the facts and circumstances available at the time of the election. The election or revocation of a spot rate convention does not change the spot rate with respect to any day of a taxable year before the election or revocation becomes effective. *See* paragraph (g) of this section for rules relating to section 987 elections.

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

(3) *Historic rate*—(i) *In general*. Except as otherwise provided in the section 987 regulations, the historic rate is determined as described in paragraphs (c)(3)(i)(A) through (E) of this section.

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

(B) *Inventory under the simplified inventory method*. If a taxpayer has not elected under §1.987-3(c)(2)(iv)(B) to use the historic inventory method, the historic rate for inventory is determined under this paragraph (c)(3)(i)(B).

(*1*) *LIFO inventory*. The historic rate for LIFO inventory is the yearly average exchange rate applicable to the year in which the inventory's LIFO layer arose.

(*2*) *Non-LIFO inventory*. The historic rate for non-LIFO inventory is the yearly average exchange rate for the relevant taxable year. For example, in determining the owner functional currency net value of a section 987 QBU on the last day of the current taxable year under §1.987-4(d)(1)(i)(A), the historic rate for non-LIFO inventory is the yearly average exchange rate for the current taxable year. In determining the owner functional currency net value of a section 987 QBU on the last day of the preceding taxable year under §1.987-4(d)(1)(i)(B), the historic rate for non-LIFO inventory is the yearly average exchange rate for the preceding taxable year.

(C) *Inventory under the historic inventory method*. If a taxpayer has elected under §1.987-3(c)(2)(iv)(B) to use the historic inventory method, each inventoriable cost with respect to a section 987 QBU's inventory may have a different historic rate. The historic rate for each inventoriable cost is the exchange rate at which the cost would be translated under §1.987-3 if it were not an inventoriable cost.

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

(E) *Determination of historic rates after revocation of current rate election*. If a current rate election is revoked or otherwise ceases to be in effect, the historic rate of all historic items (other than non-LIFO inventory subject to the simplified inventory method) that were attributable to a section 987 QBU on the last day of the last taxable year in which the current rate election was in effect is the spot rate applicable to that day. Similarly, except as provided in paragraph (c)(3)(i)(B)(*2*) of this section, if a marked item becomes a historic item (such as when an asset of an insurance company ceases to be a separate account asset), the historic rate for the historic item is equal to the spot rate applicable to the last day of the last taxable year in which it was treated as a marked item.

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

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

(d) *Marked item*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, a marked item is an asset (*marked asset*) or liability (*marked liability*) that is attributable to a section 987 QBU under §1.987-2(b) and that—

(i) Is denominated in, or determined by reference to, the functional currency of the section 987 QBU and would be a section 988 transaction if such item were held or entered into directly by the owner of the section 987 QBU;

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

(iii) Is a section 988 transaction of the section 987 QBU;

(iv) Is an insurance reserve; or

(v) Is a separate account asset.

(2) *Current rate election*. A taxpayer may elect to treat all assets and liabilities that are attributable to a section 987 QBU under §1.987-2(b) as marked items (a *current rate election*). *See* §1.987-11(c) for rules suspending section 987 loss if a current rate election is in effect.

(e) *Historic item*. A historic item is an asset (*historic asset*) or liability (*historic liability*) that is attributable to a section 987 QBU under §1.987-2(b) and that is not a marked item.

(f) *Example: Identification of marked and historic items.* The following example illustrates the application of paragraphs (d) and (e) of this section.

(1) *Facts.* U.S. Corp is a domestic corporation with the U.S. dollar as its functional currency and is the owner of Business A, a section 987 QBU that has the pound as its functional currency. Items reflected on Business A's balance sheet include £10,000, $1,000, a building with a basis of £100,000, a light general purpose truck with a basis of £30,000, a computer with a basis of £1,000, a 60-day receivable for ¥15,000, an account payable of £5,000, and a foreign currency contract within the meaning of section 1256(g)(2) that requires Business A to exchange £100 for $125 in 90 days.

(2) *Analysis*. Under paragraph (d) of this section, the £10,000, the $1,000, the ¥15,000 receivable, the £5,000 account payable, and the £/$ section 1256 foreign currency contract are marked items. The other items are historic items under paragraph (e) of this section.

(g) *Elections*. This paragraph (g) provides rules for making and revoking elections under the section 987 regulations (the *section 987 elections*). A section 987 election is made for the owner and for a taxable year and applies to every section 987 QBU owned by the owner while the election is in effect. Once made, a section 987 election remains in effect until revoked.

(1) *Persons making the election*. A section 987 election is made or revoked by the authorized person. The authorized person is described in paragraph (g)(1)(i), (ii), (iii), or (iv) of this section. If there are multiple controlling domestic shareholders, references to "the authorized person" refer to all authorized persons acting in concert.

(i) *United States persons*. Except as provided in paragraph (g)(1)(iii) or (iv) of this section, if the owner of a section 987 QBU is a United States person, the owner is the authorized person.

(ii) *CFCs*. If the owner of a section 987 QBU is a controlled foreign corporation, the controlling domestic shareholders (determined under §1.964-1(c)(5)(i)) of the controlled foreign corporation are treated as the authorized person.

(iii) *Consolidated groups*. If the owner is a member of a consolidated group, *see* §1.1502-77.

(iv) *Partnerships*. If the owner of a section 987 QBU is a partnership, the election is made or revoked by the partnership. For a partnership that is not otherwise required to file a partnership return, *see* §1.6031(a)-1(b)(5) for elections that can only be made by a partnership under section 703.

(2) *Consistency rules*—(i) *Consolidated groups*. A section 987 election is made or revoked by a consolidated group and applies to all members of the group. Therefore, the same section 987 elections will be in effect for all members of a consolidated group at all times. If a corporation becomes a member of a consolidated group, it is deemed to make or revoke any section 987 election as necessary to be consistent with the consolidated group. If a corporation ceases to be a member of a consolidated group and does not join another group, its section 987 elections are unaffected by its departure from the group. All members of a consolidated group are treated as a single United States person for purposes of applying paragraph (g)(2)(ii) of this section.

(ii) *CFCs and foreign partnerships*. If the authorized person makes or revokes an election on behalf of any person (including the authorized person) described in paragraphs (g)(2)(ii)(A) through (C) of this section (the *section 987 electing group*), then the election must be made or revoked on behalf of all members of the section 987 electing group for the first taxable year of each entity that ends with or within the taxable year of the United States person described in paragraph (g)(2)(ii)(A) of this section in which the election or revocation became effective. If an entity that was not previously a member of the section 987 electing group becomes a member (for example, upon formation or acquisition), it is deemed to make or revoke any section 987 election as necessary to be consistent with the other members (without regard to the requirements of paragraph (g)(3)(ii) of this section). The following persons are described in this paragraph (g)(2)(ii):

(A) A United States person (the *relevant United States person*).

(B) Each controlled foreign corporation in which the relevant United States person owns (within the meaning of section 958(a)) more than fifty percent of the stock (by vote or value).

(C) In the case of an election that can be made by or for a partnership, each foreign partnership in which the relevant United States person owns (directly or indirectly) more than fifty percent of the capital and profits interest.

(iii) *Section 381(a) transactions*. If a corporation (*acquiring corporation*) acquires the assets of another corporation in a transaction described in section 381(a), the acquiring corporation's election status applies to all section 987 QBUs owned by the acquiring corporation after the transaction.

(3) *Manner of making or revoking elections*. The section 987 elections must be made in accordance with this paragraph (g)(3), except as provided in forms and instructions or other guidance as provided by the Secretary.

(i) *Statement must be attached to a return*. An authorized person that makes or revokes a section 987 election in accordance with this paragraph (g) must attach to its return the statement described in this paragraph (g)(3)(i) (or must provide the information described in this paragraph (g)(3)(i) in the manner prescribed in forms or instructions or other guidance). Each statement must include an identification of the election that is made or revoked (including the section and paragraph of the regulations under which the election is made); the name, address, and functional currency of each owner (or if the owner is a member of a consolidated group, the common parent of the consolidated group) for which the election is made or revoked; and the name, address, functional currency, and owner of each section 987 QBU to which the election applies. The elections provided in §1.987-10 are made by reporting the election on the statement described in §1.987-10(k). An election to use a spot rate convention under paragraph (c)(1)(ii) of this section must describe the convention.

(ii) *Election requirements*—(A) *Consent required*. Except as provided in paragraph (g)(3)(ii)(B) or (C) of this section, a section 987 election may not be made or revoked without the consent of the Commissioner. A copy of the consent must be attached to the statement described in paragraph (g)(3)(i) of this section. For purposes of this paragraph (g)(3)(ii), the Commissioner's consent may be obtained only with a ruling or administrative pronouncement. *See* Revenue Procedure 2024-1, I.R.B. 2024-1 (or superseding guidance).

(B) *Current rate election, annual recognition election, and section 988 mark-to-market election*. Except as provided in paragraph (g)(3)(ii)(C) of this section, the authorized person may make a current rate election, an annual recognition election, or a section 988 mark-to-market election without the Commissioner's consent by filing the statement prescribed in paragraph (g)(3)(i) of this section with the Internal Revenue Service in accordance with the prescribed form or its instructions (or other guidance) on or before the first day of the taxable year to which the election applies, and attaching a copy of the statement to its return. Once made, a current rate election, annual recognition election, or section 988 mark-to-market election may not be revoked without the Commissioner's consent for any taxable year beginning within 60 months of the first day of the taxable year for which it was made. Once revoked, a new current rate election, annual recognition election, or section 988 mark-to-market election may not be made without the Commissioner's consent for any taxable year beginning within 60 months of the first day of the taxable year for which it was revoked.

(C) *First year to which the section 987 regulations apply*. The authorized person may make a section 987 election without the consent of the Commissioner on its original, timely filed (including extensions) return for the first taxable year of an owner in which both—

(*1*) The section 987 regulations apply (other than by applying solely to one or more terminating QBUs pursuant to §1.987-15(a)(2)); and

(*2*) Either the owner or any member of its consolidated group or section 987 electing group is the owner of a section 987 QBU.

(iii) *Elections made under the 2016 and 2019 section 987 regulations*. Each section 987 election must be made by the authorized person under the rules of this section without regard to whether the election was in effect under the 2016 and 2019 final regulations or under prior §1.987-8T. In the first taxable year in which the section 987 regulations apply, any elections made under the 2016 and 2019 final regulations cease to be effective.

(4) *No change in method of accounting*. An election under section 987 is not treated as a change in method of accounting for purposes of sections 446 and 481.

(5) *Principles of §1.964-1(c)(3) applicable to section 987 elections*. Except as otherwise provided in this paragraph (g), if the authorized person makes or revokes a section 987 election on behalf of a controlled foreign corporation, the authorized person must make or revoke the section 987 election in accordance with the rules and principles of §1.964-1(c)(3).

(h) *Definitions*. The definitions in this paragraph (h) apply for purposes of the section 987 regulations.

1991 proposed regulations. *1991 proposed regulations* means proposed §§ 1.987-1 through 1.987-3 as contained in 56 FR 48457-01 (September 25, 1991).

2006 proposed regulations. *2006 proposed regulations* means: proposed §§ 1.861-9T(g)(2)(ii)(A)(*1*) and (g)(2)(vi); 1.985-5; 1.987-1 through 1.987-11; 1.988-1(a)(3) and (4), (a)(10)(ii), and (i); 1.988-4(b)(2); and 1.989(a)-1(b)(2)(i), and (b)(4) as contained in 71 FR 52876-01 (September 7, 2006).

2016 and 2019 section 987 regulations. *2016 and 2019 section 987 regulations* means the following regulations:

(i) Sections 1.861-9T(g)(2)(ii)(A)(*1*) and (g)(2)(vi); 1.985-5; 1.987-1 through 1.987-10; 1.988-1(a)(4), (a)(10)(ii), and (i); 1.988-4(b)(2); and 1.989(a)-1(b)(2)(i), (b)(4), (d)(3) and (4), as contained in 26 CFR in part 1 in effect on April 1, 2017.

(ii) Sections 1.987-2T(c)(9), 1.987-4T(c)(2) and (f), and 1.987-7T, as contained in 26 CFR in part 1 in effect on April 1, 2017 (until they were revoked on May 13, 2019).

(iii) Sections 1.987-2(c)(9) and 1.987-4(c)(2) and (f), as contained in 26 CFR in part 1 in effect on April 1, 2020 (beginning on May 13, 2019).

(iv) Sections 1.987-1T (other than §§1.987-1T(g)(2)(i)(B) and (g)(3)(i)(H)), 1.987-3T, 1.987-6T, 1.988-1T, and 1.988-2T(i), as contained in 26 CFR in part 1 in effect on April 1, 2017 (until they expired on December 6, 2019).

Adjusted balance sheet. *Adjusted balance sheet* means a tax basis balance sheet in the functional currency of the eligible QBU, determined by—

(i) Preparing a balance sheet for the relevant date from the section 987 QBU's books and records (within the meaning of §1.989(a)-1(d)) recorded in the section 987 QBU's functional currency and showing all assets and liabilities attributable to the section 987 QBU under §1.987-2(b) (the *preliminary balance sheet*); and

(ii) Making adjustments necessary to conform the items reflected on the preliminary balance sheet to United States tax accounting principles (including adjustments to reflect items that were not reflected on the preliminary balance sheet but should be reflected under United States tax accounting principles, and adjustments to eliminate items that are reflected on the preliminary balance sheet but should not be reflected under United States tax accounting principles).

Annual recognition election. *Annual recognition election* has the meaning provided in §1.987-5(b)(2).

Authorized person. *Authorized person* has the meaning provided in paragraph (g)(1) of this section.

Combination. *Combination* has the meaning provided in §1.987-2(c)(9)(i).

Combined QBU. *Combined QBU* has the meaning provided in §1.987-2(c)(9)(i).

Combining QBU. *Combining QBU* has the meaning provided in §1.987-2(c)(9)(i).

Consolidated group. *Consolidated group* has the meaning provided in §1.1502-1(h).

Controlled foreign corporation. *Controlled foreign corporation* (or *CFC*) has the meaning provided in section 957 (or, if applicable, section 953(c)(1)(B)).

Controlled group. A *controlled group* means all persons with the relationships to each other specified in section 267(b) or section 707(b).

Cumulative suspended section 987 loss. *Cumulative suspended section 987 loss* has the meaning provided in §1.987-11(b).

Current rate election. *Current rate election* has the meaning provided in paragraph (d)(2) of this section.

Current year gain amount. *Current year gain amount* has the meaning provided in §1.987-11(e)(3)(i).

Deferral event. *Deferral event* has the meaning provided in §1.987-12(g)(1).

Deferred section 987 gain or loss. *Deferred section 987 gain or loss* has the meaning provided in §1.987-12(b)(2). Deferred section 987 gain or loss does not include net unrecognized section 987 gain or loss or suspended section 987 loss.

Disregarded entity. *Disregarded entity* (or *DE*) means an entity disregarded as an entity separate from its owner for Federal income tax purposes, including an entity described in §301.7701-2(c)(2) of this chapter, a qualified subchapter S subsidiary under section 1361(b)(3), a qualified REIT subsidiary within the meaning of section 856(i)(2), and a trust all of which is treated (under subpart E of part I of subchapter J of Chapter 1 of the Code) as owned by the grantor or another person.

Disregarded transactions. *Disregarded transactions* has the meaning provided in §1.987-2(c)(2)(ii).

Earnings only method. *Earnings only method* means a method of applying section 987 before the transition date under which gain or loss under section 987(3) is determined only with respect to the earnings of a section 987 QBU.

ECI. *ECI* means income that is effectively connected with the conduct of a trade or business within the United States.

Eligible pretransition method. *Eligible pretransition method* has the meaning provided in §1.987-10(e)(4).

Eligible QBU. *Eligible QBU* has the meaning provided in paragraph (b)(4) of this section.

Financial instrument. *Financial instrument* has the meaning provided in §1.1275-6(b)(3). It includes a financial instrument entered into between related parties or unrelated parties.

Foreign source income. *Foreign source income* means income from sources without the United States.

Generally accepted accounting principles. *Generally accepted accounting principles* means United States generally accepted accounting principles described in standards established and made effective by the Financial Accounting Standards Board.

Hedge. *Hedge* has the meaning provided in §1.987-14(b)(1).

Hedged QBU. *Hedged QBU* has the meaning provided in §1.987-14(b)(1).

Hedging gain or loss. *Hedging gain or loss* has the meaning provided in §1.987-14(d)(1).

Historic asset. *Historic asset* has the meaning provided in paragraph (e) of this section.

Historic item. *Historic item* has the meaning provided in paragraph (e) of this section.

Historic liability. *Historic liability* has the meaning provided in paragraph (e) of this section.

Historic rate. *Historic rate* has the meaning provided in paragraph (c)(3) of this section.

Insurance reserve. *Insurance reserve* means an item that is a reserve under section 807(c) or section 953(b) (as applicable).

LIFO. *LIFO* means the last-in, first-out inventory method (as described in section 472).

LIFO inventory. *LIFO inventory* means inventory accounted for under the LIFO inventory method.

Liability. *Liability* means the amount of a liability on the adjusted balance sheet (or the amount that would be on the adjusted balance sheet if an adjusted balance sheet were prepared for that day).

Lookback gain amount. *Lookback gain amount* has the meaning provided in §1.987-11(e)(3)(ii).

Lookback period. *Lookback period* has the meaning provided in §1.987-11(e)(3)(iv).

Loss-to-the-extent-of-gain rule. *Loss-to-the-extent-of-gain rule* has the meaning provided in §1.987-11(e)(1).

Marked asset. *Marked asset* has the meaning provided in paragraph (d) of this section.

Marked item. *Marked item* has the meaning provided in paragraph (d) of this section.

Marked liability. *Marked liability* has the meaning provided in paragraph (d) of this section.

Net accumulated unrecognized section 987 gain or loss. *Net accumulated unrecognized section 987 gain or loss* has the meaning provided in §1.987-4(c).

Net unrecognized section 987 gain or loss. *Net unrecognized section 987 gain or loss* has the meaning provided in §1.987-4(b). Net unrecognized section 987 gain or loss does not include deferred section 987 gain or loss or suspended section 987 loss.

Non-LIFO inventory. *Non-LIFO inventory* means inventory that is not accounted for under the LIFO inventory method.

Original deferral QBU. *Original deferral QBU* has the meaning provided in §1.987-12(b).

Original deferral QBU owner. *Original deferral QBU owner* has the meaning provided in §1.987-12(g)(3).

Original suspended loss QBU owner. *Original suspended loss QBU owner* has the meaning provided in §1.987-13(l)(1).

Outbound loss event. *Outbound loss event* has the meaning provided in §1.987-13(h)(2).

Outbound loss QBU. *Outbound loss QBU* has the meaning provided in §1.987-13(h)(1).

Outbound section 987 loss. *Outbound section 987 loss* has the meaning provided in §1.987-13(h)(4).

Owner. *Owner* has the meaning provided in paragraph (b)(5) of this section.

Prior §1.987-1. *Prior §1.987-1* means §1.987-1, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-4. *Prior §1.987-4* means §1.987-4, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-5. *Prior §1.987-5* means §1.987-5, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-8T. *Prior §1.987-8T* means §1.987-8T, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-10. *Prior §1.987-10* means §1.987-10, as contained in 26 CFR in part 1 in effect on April 1, 2017.

Prior §1.987-12. *Prior §1.987-12* means §1.987-12, as contained in 26 CFR in part 1 in effect on April 1, 2020.

Prior §1.987-12T. *Prior §1.987-12T* means §1.987-12T, as contained in 26 CFR in part 1 in effect on April 1, 2017.

QBU net value. *QBU net value* has the meaning provided in §1.987-4(e)(2)(ii).

Recognition grouping. *Recognition grouping* has the meaning provided in §1.987-11(f).

Remittance. *Remittance* has the meaning provided in §1.987-5(c).

S corporation. *S corporation* has the meaning provided in section 1361(a)(1).

Section 904 category. *Section 904 category* means a separate category of income described in §1.904-5(a)(4)(v).

Section 987 electing group. *Section 987 electing group* has the meaning provided in paragraph (g)(2)(ii) of this section.

Section 987 elections. *Section 987 elections* has the meaning provided in paragraph (g) of this section.

Section 987 gain or loss. *Section 987 gain or loss* means gain or loss that is recognized under §1.987-5, deferred section 987 gain or loss, suspended section 987 loss, and pretransition gain or loss that is recognized under §1.987-10(e)(5)(ii).

Section 987 hedging transaction. *Section 987 hedging transaction* has the meaning provided in §1.987-14(b).

Section 987 QBU. *Section 987 QBU* has the meaning provided in paragraph (b)(3) of this section.

Section 987 regulations. *Section 987 regulations* has the meaning provided in paragraph (a) of this section.

Section 987 taxable income or loss. *Section 987 taxable income or loss* has the meaning provided in §1.987-3(a).

Section 988 mark-to-market election. *Section 988 mark-to-market election* has the meaning provided in §1.987-3(b)(4)(ii).

Separate account. *Separate account* means a separate set of financial records maintained with respect to an insurance contract or group of contracts to report assets and liabilities for specific products that are separated from the insurer's general account, provided the following requirements are met—

(i) Any liability of the separate account is the liability only of that account and not the liability of any other separate account or the general account;

(ii) The separate account is not part of the company's general account and is protected from the general creditors of the company; and

(iii) The value of each contract supported by the separate account is supported proportionately by each of the assets in such account.

Separate account asset. *Separate account asset* means an asset that is reflected on the books and records of an eligible QBU and held in a separate account with respect to a separate account insurance contract. A separate account asset does not include an asset held in the general account.

Separate account insurance contract. *Separate account insurance contract* means a contract that would be treated as an insurance contract for Federal income tax purposes (except to the extent provided in this definition with respect to the requirements in section 72(s), 101(f), 817(h), or 7702) for which some or all of the assets supporting the insurance reserves are required to be held in a separate account under the insurance regulatory rules of the jurisdiction in which the contract is issued, and either—

(i) The contract qualifies as a variable contract under section 817(d) (treating foreign law as a State law or regulation); or

(ii) The contract would qualify as a variable contract under section 817(d) (treating foreign law as a State law or regulation) but for its failure to meet one or more of the requirements in section 72(s), 101(f), 817(h), or 7702, provided that the following requirements are met—

(A) The contract is regulated as a life insurance or annuity contract in the foreign jurisdiction in which it is issued;

(B) The contract reserves are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. For this purpose, the reflection of the investment return and the market value of assets in the separate account is considered an assumed rate of interest; and

(C) No policyholder, annuitant, insured, or beneficiary under the contract is a United States person.

Separated QBU. *Separated QBU* has the meaning provided in §1.987-2(c)(9)(iii).

Separating QBU. *Separating QBU* has the meaning provided in §1.987-2(c)(9)(iii).

Separation. *Separation* has the meaning provided in §1.987-2(c)(9)(iii).

Separation fraction. In the case of a separated QBU, *separation fraction* means a fraction, the numerator of which is the aggregate adjusted basis of the gross assets attributable to the separated QBU immediately after the separation, and the denominator of which is the aggregate adjusted basis of the gross assets attributable to all separated QBUs immediately after the separation.

Spot rate. *Spot rate* has the meaning provided in paragraph (c)(1) of this section.

SRLY section 987 losses. *SRLY section 987 losses* has the meaning provided in §1.987-11(e)(6)(ii).

Successor deferral QBU. *Successor deferral QBU* has the meaning provided in §1.987-12(g)(2).

Successor deferral QBU owner. *Successor deferral QBU owner* has the meaning provided in §1.987-12(c)(1).

Successor suspended loss QBU. *Successor suspended loss QBU* has the meaning provided in §1.987-13(l)(2).

Successor suspended loss QBU owner. *Successor suspended loss QBU owner* has the meaning provided in §1.987-13(l)(3).

Suspended section 987 loss. *Suspended section 987 loss* means section 987 loss that is subject to the limitations on recognition described in §1.987-11(e). *See* §§1.987-10(e)(5), 1.987-11(c) and (d), 1.987-12(c), and 1.987-13(h) for rules regarding when net unrecognized section 987 loss or deferred section 987 loss becomes suspended section 987 loss. Suspended section 987 loss does not include net unrecognized section 987 loss or deferred section 987 loss.

Tentative tested income group. *Tentative tested income group* has the meaning provided in §1.987-6(b)(2)(i)(D)(*1*).

Terminating QBU. *Terminating QBU* means a section 987 QBU, if both—

(i) The section 987 QBU terminates on any date on or after November 9, 2023, or the section 987 QBU terminates as a result of an entity classification election made under §301.7701-3 of this chapter that is filed on or after November 9, 2023, and that is effective before November 9, 2023; and

(ii) When the section 987 QBU terminates, neither the section 987 regulations nor the 2016 and 2019 section 987 regulations would apply with respect to the section 987 QBU but for §1.987-15(a)(2).

Termination. With respect to a section 987 QBU, *termination* has the meaning provided in §1.987-8(b) and (c). With respect to a successor suspended loss QBU, the term *termination* has the meaning provided in §1.987-13(j).

Trade or business. *Trade or business* has the meaning provided in §1.989(a)-1(c).

Transfer. *Transfer* has the meaning provided in §1.987-2(c).

Transition date. *Transition date* has the meaning provided in §1.987-10(c).

United States person. *United States person* (or *U.S. person*) has the meaning provided in section 7701(a)(30).

United States shareholder. *United States shareholder* (or *U.S. shareholder*) has the meaning provided in section 951(b) (or, if applicable, section 953(c)(1)(A)).

U.S. source income. *U.S. source income* means income from sources within the United States.

Yearly average exchange rate. *Yearly average exchange rate* has the meaning provided in paragraph (c)(2) of this section.

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

(a) *In general*. This section provides rules regarding when items are attributed to eligible QBUs and when they are treated as transferred to or from section 987 QBUs. Paragraph (b) of this section provides rules for attributing assets and liabilities, and items of income, gain, deduction, and loss, to an eligible QBU. Paragraph (c) of this section defines a transfer to or from a section 987 QBU. Paragraph (d) of this section provides translation rules for transfers to a section 987 QBU. Paragraph (e) of this section provides a cross-reference relating to the treatment of section 987 QBUs owned by consolidated groups.

(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)(1) and (2), of the eligible QBU. For purposes of this section, the term *item* refers to any asset or liability, and any item of income, gain, deduction, or loss. Items that are attributed to an eligible QBU pursuant to this section must be adjusted to conform to Federal income tax principles. An item that is not taken into account for financial accounting purposes, and therefore is not reflected on the separate set of books and records of an eligible QBU, is treated as reflected on the separate set of books and records of an eligible QBU to the extent it would have been so reflected if the item were taken into account for financial accounting purposes. Except as provided in §1.989(a)-1(d)(3), these attribution rules apply solely for purposes of section 987. For example, the allocation and apportionment of interest expense under section 864(e) is independent of these rules.

(2) *Exceptions for non-portfolio stock, interests in partnerships, and certain acquisition indebtedness*. (i) *In general*. Except as provided in paragraph (b)(2)(ii) of this section, the following items are not considered to be on the books and records of an eligible QBU:

(A) Stock of a corporation (whether domestic or foreign), other than stock of a corporation if the owner of the eligible QBU owns less than 10 percent of the total combined voting power of all classes of stock entitled to vote and less than 10 percent of the total value of all classes of stock of such corporation. For this purpose, section 958 (other than section 958(b)(1)) applies in determining ownership of a controlled foreign corporation and section 318(a) applies in determining ownership of other corporations, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

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

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

(D) Income, gain, deduction, or loss arising from the items described in paragraphs (b)(2)(i)(A) through (C) of this section. For example, if a dividend is received with respect to stock of a corporation described in paragraph (b)(2)(i)(A) of this section, the dividend is excluded from the income of the eligible QBU. *See also* paragraph (c)(2)(ii) of this section, treating the payment as received by the owner and contributed to the eligible QBU.

(ii) *Separate account assets*. Paragraph (b)(2)(i) of this section does not apply to separate account assets, liabilities related to separate account assets, or income, gain, deduction, or loss arising from those assets and liabilities.

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

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

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

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

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

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

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

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

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

(iii) *Factors indicating tax avoidance*. For purposes of paragraph (b)(3)(i) of this section, factors that may indicate that a principal purpose of recording (or not recording) an item on the books and records of an eligible QBU is the avoidance of Federal income tax under, or through the use of, section 987 include:

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

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

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

(iv) *Section 988 transactions*. A section 988 transaction that is reflected on the books and records of an eligible QBU is not attributable to an eligible QBU if the transaction was entered into or was reflected on the eligible QBU's books and records with a principal purpose of generating fully or partially offsetting amounts of section 988 gain or loss and section 987 gain or loss (or if the taxpayer chose to denominate the section 988 transaction in a nonfunctional currency with such a principal purpose).

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

(2) *Disregarded transactions*—(i) *General rule*. An asset or liability is treated as transferred to a section 987 QBU from its owner if, as a result of a disregarded transaction, such asset or liability is reflected on the books and records of (or otherwise becomes attributable to) the section 987 QBU within the meaning of paragraph (b) of this section. Similarly, an asset or liability is treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, such asset or liability is no longer reflected on the books and records of (or otherwise ceases to be attributable to) the section 987 QBU within the meaning of paragraph (b) of this section.

(ii) *Definition of a disregarded transaction*. For purposes of this section, a disregarded transaction means a transaction that is not regarded for Federal income tax purposes (for example, any transaction between separate section 987 QBUs of the same owner). For purposes of this paragraph (c), a disregarded transaction is treated as including events described in paragraphs (c)(2)(ii)(A) through (F) of this section.

(A) If the recording (or not recording) of an asset or liability on the books and records of a section 987 QBU of an owner is the result of such asset or liability being removed from (or included on) the books and records of the owner or another eligible QBU of the owner, the asset or liability is treated as transferred to (or from) the section 987 QBU in a disregarded transaction.

(B) If an asset or liability that was previously attributable to a section 987 QBU of an owner begins to be attributable to the owner (or another eligible QBU of the owner) as a result of the application of paragraph (b)(2) or (3) of this section, the asset or liability is treated as having been transferred by the section 987 QBU in a disregarded transaction. If an asset or liability that was previously attributable to the owner (or another eligible QBU of the owner) begins to be attributable to the section 987 QBU as a result of the application of paragraph (b)(2) or (3) of this section, the asset or liability is treated as transferred to the section 987 QBU in a disregarded transaction.

(C) If an asset or liability that is attributable to a section 987 QBU is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is not attributable to the section 987 QBU immediately after the sale or exchange, the sold or exchanged asset or liability that was attributable to the section 987 QBU immediately before the transaction is treated as transferred from the section 987 QBU to its owner in a disregarded transaction immediately before the sale or exchange for purposes of section 987 (including for purposes of recognizing section 987 gain or loss under §1.987-5) and subsequently sold or exchanged by the owner.

(D) If an asset or liability of an owner of a section 987 QBU that is not attributable to a section 987 QBU is sold or exchanged (including in a nonrecognition transaction, such as an exchange under section 351) for an asset or liability that is attributable to the section 987 QBU immediately after the sale or exchange, the asset or liability that is attributable to the section 987 QBU immediately after the transaction is treated as received or assumed by the owner and transferred from the owner to the section 987 QBU in a disregarded transaction immediately after the sale or exchange for purposes of section 987 (including for purposes of recognizing section 987 gain or loss under §1.987-5).

(E) If an asset or liability that is attributable to a section 987 QBU was received, transferred, assumed, or accrued in a regarded transaction (including the making or receiving of a payment) in which the related item of income, gain, deduction, or loss is not attributable to the section 987 QBU, the asset or liability is treated as though it was received, transferred, assumed, or accrued by the owner or another eligible QBU and transferred to or from the section 987 QBU in a disregarded transaction. Similarly, if an asset or liability that is not attributable to a section 987 QBU was received, transferred, assumed, or accrued in a regarded transaction (including the making or receiving of a payment) in which the related item of income, gain, deduction, or loss is attributable to the section 987 QBU, the asset or liability is treated as though it was received, transferred, assumed, or accrued by the section 987 QBU and transferred to or from the section 987 QBU in a disregarded transaction. For example, if a section 987 QBU receives a dividend on an interest in stock that would be attributable to the section 987 QBU but for paragraph (b)(2)(i)(A) of this section, the owner is treated as receiving the dividend and transferring to the section 987 QBU the amount of the dividend in a disregarded transaction. Similarly, if a section 987 QBU pays interest on a liability that would be attributable to the section 987 QBU but for paragraph (b)(2)(i)(C) of this section, the section 987 QBU is treated as transferring to the owner the amount of the interest expense and the owner is treated as paying the interest expense in a disregarded transaction. *See also* paragraph (c)(7) of this section (application of general tax law principles).

(F) In the first taxable year in which an eligible QBU is treated as a section 987 QBU, all assets and liabilities attributable to the eligible QBU are treated as transferred from the owner to the section 987 QBU in a disregarded transaction on the first day on which the eligible QBU is treated as a section 987 QBU.

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

(3) through (6) [Reserved]

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

(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) *Certain disregarded transactions not treated as transfers*—(i) *Combinations of section 987 QBUs*. The combination (a *combination*) of two or more separate section 987 QBUs (*combining QBUs*) that are directly owned by the same owner into one section 987 QBU (*combined QBU*) does not give rise to a transfer of any combining QBU's assets or liabilities to the owner under this paragraph (c). In addition, transactions between the combining QBUs occurring in the taxable year of the combination do not result in a transfer of the combining QBUs' assets or liabilities to the owner under this paragraph (c). For this purpose, a combination occurs when the assets and liabilities that were attributable to two or more combining QBUs begin to be attributable to a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which the combining QBUs become a combined QBU. A combination may also result when an owner of two or more section 987 QBUs with the same functional currency becomes subject to a grouping election under §1.987-1(b)(3)(ii) or when a section 987 QBU of an owner subject to a grouping election changes its functional currency to that of another section 987 QBU of the same owner. For purposes of determining net unrecognized section 987 gain or loss, deferred section 987 gain or loss, and cumulative suspended section 987 loss of a combined QBU, the combining QBUs are treated as having combined immediately before the beginning of the taxable year of combination. *See* §§1.987-4(f)(1), 1.987-11(b)(2), and 1.987-12(f)(1).

(ii) *Change in functional currency from a combination*. If, following a combination of section 987 QBUs described in paragraph (c)(9)(i) of this section, the combined section 987 QBU has a different functional currency than one or more of the combining section 987 QBUs, any such combining section 987 QBU is treated as changing its functional currency, and the owner of the combined section 987 QBU must comply with the regulations under section 985 regarding the change in functional currency. *See* §§1.985-1(c)(6) and 1.985-5.

(iii) *Separation of section 987 QBUs*. The separation (a *separation*) of a section 987 QBU (*separating QBU*) into two or more section 987 QBUs (*separated QBUs*) that, after the separation, are directly owned by the same owner does not result in a transfer of the separating QBU's assets or liabilities to the owner under this paragraph (c). Additionally, transactions that occurred between the separating QBUs in the taxable year of the separation before the completion of the separation do not result in transfers for purposes of section 987. For this purpose, a separation occurs when the assets and liabilities that were attributable to a separating QBU begin to be attributable to two or more separated QBUs and each of the separated QBUs continues to perform a significant portion of the separating QBU's activities immediately after the separation. A separation may result from any transaction or series of transactions in which a separating QBU becomes two or more separated QBUs described in the preceding sentence. A separation may also result when a section 987 QBU that is subject to a grouping election under §1.987-1(b)(3)(ii) changes its functional currency or when the grouping election is revoked. For purposes of determining net unrecognized section 987 gain or loss, deferred section 987 gain or loss, or cumulative suspended section 987 loss of a separated QBU, the separating QBU is treated as having separated immediately before the beginning of the taxable year of separation. *See* §§1.987-4(f)(2), 1.987-11(b)(3), and 1.987-12(f)(2).

(iv) *Special rules for successor suspended loss QBUs*. For purposes of determining whether a combination or separation has occurred with respect to a successor suspended loss QBU, the rules of paragraphs (c)(9)(i) and (iii) of this section are applied without regard to whether any of the combining QBUs, the combined QBU, the separating QBU, or the separated QBUs are section 987 QBUs. A combined QBU is a successor suspended loss QBU if either combining QBU was a successor suspended loss QBU, and a separated QBU is a successor suspended loss QBU if the separating QBU was a successor suspended loss QBU.

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

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

(B) *Analysis*—(*1*) The loan from X to DE1 is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). Because DE1 is a DE, the DE1 note held by X and the liability of DE1 under the note are not taken into account under this section.

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

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

(B) *Analysis*. The transfer of the equipment from the books and records of Business A to the books and records of Business B is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). Therefore, for purposes of section 987, the Business A section 987 QBU is treated as transferring the equipment to X, and X is subsequently treated as transferring the equipment to the Business B section 987 QBU. These transfers are taken into account in determining the amount of any remittance for the taxable year under §1.987-5(c).

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

(B) *Analysis*—(*1*) The sale of equipment between DE1 and DE2 is a transaction that is not regarded for Federal income tax purposes (because it is an interbranch transaction) and therefore the transaction is a disregarded transaction (as defined in paragraph (c)(2)(ii) of this section). Pursuant to paragraph (c)(2)(iii) of this section, the sale does not give rise to an item of income, gain, deduction, or loss for purposes of determining section 987 taxable income or loss under §1.987-3. However, the yen and equipment exchanged by DE1 and DE2 in connection with the sale must be taken into account as a transfer under paragraph (c)(2)(i) of this section.

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

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

(iv) through (ix) [Reserved]

(x) *Example 10: Contribution of a section 987 QBU's assets to a corporation*—(A) *Facts*. X owns Business A. X forms Z, a domestic corporation, contributing 50 percent of its Business A assets and liabilities to Z in exchange for all of the stock of Z. X and Z do not file a consolidated tax return.

(B) *Analysis*. Pursuant to paragraph (b)(2) of this section, the Z stock received in exchange for 50 percent of Business A's assets and liabilities is not reflected on the books and records of, and therefore is not attributable to, Business A for purposes of section 987 immediately after the exchange. As a result, pursuant to paragraphs (c)(2)(i) and (ii) of this section, 50 percent of the assets and liabilities of Business A are treated as transferred from Business A to X in a disregarded transaction immediately before the exchange. *See* §1.1502-13(j)(9) if X and Z file a consolidated return.

(xi) *Example 11: Circular transfers*—(A) *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 net 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.

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

(xii) *Example 12: Transfers without substance*—(A) *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 net 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.

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

(xiii) *Example 13: Offsetting positions in section 987 QBUs*—(A) *Facts*. X owns Business A and Business B. Business A and Business B each have the euro as their functional currency. X has not made a grouping election under §1.987-1(b)(3)(ii). On January 1, year 1, X borrows €1,000 from a third-party lender, records the liability with respect to the borrowing on the books and records of Business A, and records the borrowed €1,000 on the books and records of Business B. On December 31, 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, X terminates the Business A section 987 QBU.

(B) *Analysis*. Under paragraph (b)(3) of this section, the fact that Business A and Business B have offsetting positions in the euro is a factor indicating that a principal purpose of recording the euro-denominated liability on the books and records of Business A and the borrowed euros on the books and records of Business B was the avoidance of tax under section 987. If such a principal purpose is present, the items must be reallocated (that is, the euros and the euro-denominated liability) between Business A, Business B, and X under paragraph (b)(3) of this section to reflect the substance of the transaction.

(xiv) *Example 14: Offsetting positions with respect to a section 987 QBU and a section 988 transaction*—(A) *Facts*. X owns all of the interests in 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 change in exchange rates with respect to the €1,000 received from the borrowing, and when the euro-denominated borrowing, if repaid, would result in $100 of gain under section 988, X terminates the Business A section 987 QBU.

(B) *Analysis*. Under paragraph (b)(3) of this section, the fact that X and Business A have offsetting positions in the euro is a factor indicating that 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 items (that is, the euros and the euro-denominated liability) must be reallocated between Business A and X under paragraph (b)(3) of this section to reflect the substance of the transaction.

(xv) *Example 15: Offsetting positions with respect to a section 987 QBU and a section 988 transaction*—(A) *Facts*. X owns all of the stock of Y and all of the interests in DE1. DE1 owns Business A. X and Y do not file a consolidated return. On January 1, year 1, DE1 lends €1,000 to Y. X records the receivable with respect to the loan on Business A's books and records. On December 31, year 2, when Business A has $100 of net unrecognized section 987 gain resulting from the loan, Y repays the €1,000 liability. The repayment of the euro-denominated borrowing results in $100 of loss to Y under section 988. Business A does not make any remittances to X in year 2, so the offsetting gain with respect to the loan receivable has not been recognized by X.

(B) *Analysis*. Under paragraph (b)(3) of this section, the fact that Y (a related party to X) and Business A have offsetting positions in the euro is a factor indicating that a principal purpose of recording the euro-denominated receivable on the books and records of Business A, rather than on the books and records of X, was to avoid Federal income tax under, or through the use of, section 987. If such a principal purpose is present, the euro-denominated receivable must be reallocated between Business A and X under paragraph (b)(3) of this section to reflect the substance of the transaction. Other provisions (for example, section 267) may also apply to defer or disallow the loss. *See* §1.1502-13(j)(9) if X and Y file a consolidated return.

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

(B) *Analysis*. Under paragraph (b)(3) of this section, if a principal purpose of recording of the loan on the books and records of Business A, rather than on the books and records of X, was to avoid Federal income tax under, or through the use of, section 987, the items must be reallocated to reflect the substance of the transaction (for example, by moving the loan onto the books of X, resulting in the transfer not being taken into account for purposes of section 987).

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

(B) *Analysis*. Under general tax law principles as provided in paragraph (c)(7) of this section, on July 1, year 1, Business A is treated for purposes of section 987 as making a transfer of €20 to X, and X is treated as making a €20 interest payment to the bank. *See also* paragraph (c)(2)(ii)(E) of this section for interest payments on loans that are not attributable to a section 987 QBU pursuant to paragraph (b)(2) or (3) of this section.

(xviii) *Example 18: Sale of the interests in a DE*—(A) *Facts*. X owns all of the interests in DE1, a disregarded entity. DE1 owns Business A, which is a section 987 QBU of X. X has made a current rate election under §1.987-1(d)(2) but not an annual recognition election under §1.987-5(b)(2). On December 31, year 1, X sells all of the interests in DE1 to FC, an unrelated foreign corporation, for $150,000, when the exchange rate is €1=$1.2. The sale proceeds are reflected on X's books and records after the sale. At the time of the sale, all of DE1's assets are used in Business A and are reflected on the books and records of Business A. The assets have a basis of €100,000 and Business A has no liabilities. In year 1, X has net unrecognized section 987 gain with respect to Business A of $20,000.

(B) *Analysis*—(*1*) Under paragraph (c)(2)(ii)(C) of this section, if an asset that is attributable to a section 987 QBU is sold or exchanged for an asset that is not attributable to the section 987 QBU immediately after the sale or exchange, the sold or exchanged asset is treated as transferred from the section 987 QBU to its owner in a disregarded transaction immediately before the sale or exchange and subsequently sold or exchanged by the owner. The sale of DE1 is treated as a sale of the assets of Business A in exchange for cash that is not reflected on the books and records of the Business A section 987 QBU. Therefore, the assets of Business A are treated as transferred from the Business A section 987 QBU to X, and X is treated as selling the assets to FC.

(*2*) The deemed transfer of all of Business A's assets to X results in a termination of the Business A section 987 QBU under §1.987-8(b)(2) (substantially all assets transferred). Under §1.987-5(c)(4) and §1.987-8(e), a termination of a section 987 QBU is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of the termination. Therefore, the owner's remittance proportion is one, and X recognizes all of its net unrecognized section 987 gain with respect to Business A, or $20,000.

(*3*) Because a current rate election was in effect, all of the assets of Business A are marked items. Therefore, under §1.987-5(f)(2), X's basis in the assets transferred from Business A is determined by translating Business A's functional currency basis in the assets into X's functional currency at the spot rate applicable to the date of the transfer, €1=$1.2. Consequently, immediately before the sale of the interests in DE1, X's functional currency basis in Business A's assets (which Business A held with a basis of €100,000) is $120,000. X recognizes $30,000 of gain under section 1001(a) on the sale of DE1.

(d) *Translation of items transferred to a section 987 QBU*—(1) *Marked items*. The adjusted basis of a marked asset, or the amount of a marked liability, transferred to a section 987 QBU is translated into the section 987 QBU's functional currency at the spot rate applicable to the date of transfer. If, and to the extent that, exchange gain or loss is recognized on the asset or liability transferred under §1.988-1(a)(10)(ii), the adjusted basis of the marked asset, or the amount of the marked liability, is adjusted to take into account the exchange gain or loss recognized.

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

(e) *Cross-reference*. *See also* §1.1502-13(j)(9) regarding the treatment of intercompany transactions involving section 987 QBUs owned by a member of a consolidated group.

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

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

(b) *Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency*—(1) *In general*. The owner of a section 987 QBU must determine each item of income, gain, deduction, or loss attributable to the section 987 QBU in the section 987 QBU's functional currency under Federal income tax principles.

(2) *Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency*. Except as otherwise provided in paragraph (b)(4) of this section, an item of income, gain, deduction, or loss (or the item's components and related items, such as gross receipts and amount realized) that is denominated in (or determined by reference to) a nonfunctional currency (including the functional currency of the owner) is translated into the section 987 QBU's functional currency at the spot rate on the date such item is properly taken into account. Paragraphs (e)(1) and (2) of this section (*Examples 1* and *2)* illustrate the application of this paragraph (b)(2).

(3) [Reserved]

(4) *Section 988 transactions*—(i) *In general.* Section 988 and the regulations under section 988 apply to section 988 transactions of a section 987 QBU. The determination of whether an asset or liability of a section 987 QBU is a section 988 transaction is determined by reference to the functional currency of the section 987 QBU. Section 988 gain or loss is determined in, and by reference to, the functional currency of the section 987 QBU. The amount of section 988 gain or loss determined under this paragraph (b)(4)(i) is translated into the owner's functional currency under paragraph (c) of this section.

(ii) *Section 988 mark-to-market election*—(A) *In general*. A taxpayer may elect to apply the section 988 mark-to-market method of accounting described in this paragraph (b)(4)(ii) with respect to all section 988 transactions that are properly attributable to a section 987 QBU and that are not otherwise accounted for under a mark-to-market method of accounting under section 475 or section 1256 (other than a section 988 transaction described in paragraph (b)(4)(ii)(B) of this section). Under the section 988 mark-to-market method of accounting, the timing of section 988 gain or loss on section 988 transactions described in the preceding sentence is determined under the principles of section 1256. Only section 988 gain or loss is taken into account under the foreign currency mark-to-market method of accounting. Appropriate adjustments must be made to prevent the section 988 gain or loss from being taken into account again after it is recognized under this paragraph (b)(4)(ii). A section 988 transaction subject to the foreign currency mark-to-market method of accounting is not subject to the netting rule of section 988(b) and §1.988–2(b)(8) (under which exchange gain or loss is limited to overall gain or loss realized in a transaction) in taxable years before the taxable year in which section 988 gain or loss would be recognized with respect to the section 988 transaction but for this election.

(B) *Built-in loss transactions contributed to a section 987 QBU*. Paragraph (b)(4)(ii)(A) of this section does not apply to a section 988 transaction if—

(*1*) The transaction was transferred to the section 987 QBU from its owner (or from another eligible QBU of the owner);

(*2*) Immediately before the transfer, the transaction was a section 988 transaction in the hands of the owner (or other eligible QBU of the owner) and was not subject to a mark-to-market method of accounting;

(*3*) If the owner (or other eligible QBU) had disposed of the section 988 transaction immediately before the transfer (and §1.988-2(b)(8) did not apply), the owner would have recognized section 988 loss; and

(*4*) Section 988 loss was not recognized in connection with the transfer under §1.988-1(a)(10).

(c) *Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency*—(1) *In general*. Except as otherwise provided in this section, the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss attributable to a section 987 QBU (or the item's components and related items, such as gross receipts, amount realized, basis, and cost of goods sold) into the owner's functional currency, if necessary, is the yearly average exchange rate for the taxable year.

(2) *Exceptions*. Except as otherwise provided in paragraph (c)(2)(v) of this section, this paragraph (c)(2) applies only to taxable years for which neither the annual recognition election nor the current rate election is in effect.

(i) *Recovery of basis with respect to historic assets*. Except as otherwise provided in this paragraph (c)(2), the exchange rate to be used by the owner in translating any recovery of basis (whether through a sale or exchange; deemed sale or exchange; cost recovery deduction such as depreciation, depletion or amortization; or otherwise) with respect to a historic asset is the historic rate for the property to which such recovery of basis is attributable.

(ii) through (iii) [Reserved]

(iv) *Cost of goods sold computation*—(A) *General rule—simplified inventory method*. Except as otherwise provided in paragraph (c)(2)(iv)(B) of this section, cost of goods sold (*COGS*) for a taxable year is translated into the functional currency of the owner at the yearly average exchange rate for the taxable year in which the sale of inventory occurs (or the COGS is otherwise taken into account in computing taxable income) and adjusted as provided in paragraph (c)(3) of this section.

(B) *Election to use the historic inventory method*. In lieu of using the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section, the owner of a section 987 QBU may elect under this paragraph (c)(2)(iv)(B) to translate inventoriable costs (including current-year inventoriable costs and costs that were capitalized into inventory in prior years) that are included in COGS at the historic rate for each such cost.

(v) *Translation of income to account for certain foreign income tax claimed as a credit.* The owner of a section 987 QBU claiming a credit under section 901 for foreign income taxes, other than foreign income taxes deemed paid under section 960, that are properly reflected on the books and records of the section 987 QBU (the creditable tax amount) must determine section 987 taxable income or loss attributable to the section 987 QBU by reducing the amount of section 987 taxable income or loss that otherwise would be determined under this section by an amount equal to the creditable tax amount, translated into U.S. dollars using the yearly average exchange rate for the taxable year in which the creditable tax is accrued, and by increasing the resulting amount by an amount equal to the creditable tax amount, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a). This paragraph (c)(2)(v) applies whether or not a current rate election or an annual recognition election is in effect. *See* paragraph (e)(14) of this section (*Example 14)* for an illustration of this rule.

(3) *Adjustments to COGS required under the simplified inventory method*. This paragraph (c)(3) applies only to taxable years for which neither the annual recognition election nor the current rate election is in effect.

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

(ii) *Adjustment for cost recovery deductions included in inventoriable costs*—(A) *In general*. The translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section is increased or decreased (as appropriate) by the amount described in paragraph (c)(3)(ii)(B) of this section. The adjustment is included as an adjustment to translated COGS computed under paragraph (c)(2)(iv)(A) of this section in full in the year to which the adjustment relates and is not allocated between COGS and ending inventory.

(B) *Amount of adjustment*. With respect to each cost recovery deduction attributable to a historic asset that is included in inventoriable costs for a taxable year, the adjustment is equal to—

(*1*) The amount of the cost recovery deduction included in inventoriable costs, translated at the historic rate for the property to which the deduction is attributable; less

(*2*) The amount of the cost recovery deduction included in inventoriable costs, translated at the yearly average exchange rate for the current taxable year.

(iii) *Adjustment for beginning inventory for non-LIFO inventory*—(A) *In general.* In the case of non-LIFO inventory, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section is increased or decreased (as appropriate) by the amount described in paragraph (c)(3)(iii)(B) of this section.

(B) *Amount of adjustment*. The adjustment is equal to—

(*1*) The ending non-LIFO inventory included on the closing balance sheet for the preceding taxable year, translated at the exchange rate described in paragraph (c)(3)(iii)(C) of this section (which is generally the yearly average exchange rate for the preceding taxable year); less

(*2*) The ending non-LIFO inventory included on the closing balance sheet for the preceding taxable year, translated at the yearly average exchange rate for the current taxable year.

(C) *Exchange rate*—(*1*) *In general*. Except as provided in paragraph (c)(3)(iii)(C)(*2*) of this section, the exchange rate used to translate non-LIFO inventory under paragraph (c)(3)(iii)(B)(*1*) of this section is the yearly average exchange rate for the preceding taxable year.

(*2*) *Revocation of current rate election or taxable year beginning on the transition date*. In the first taxable year in which a current rate election is revoked or otherwise ceases to be in effect (or in the taxable year beginning on the transition date), the exchange rate used to translate non-LIFO inventory under paragraph (c)(3)(iii)(B)(*1*) of this section is the spot rate applicable to the last day of the preceding taxable year.

(iv) *Adjustment for year of LIFO liquidation*—(A) *In general*. In the case of inventory with respect to which a section 987 QBU uses the LIFO inventory method, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section is increased or decreased (as appropriate) by the amount described in paragraph (c)(3)(iv)(B) of this section.

(B) *Amount of adjustment*. With respect to each LIFO layer liquidated in whole or in part during the taxable year, the adjustment is equal to:

(*1*) The amount of the LIFO layer liquidated during the taxable year, translated at the historic rate that is used for translating the LIFO layer (which is generally the yearly average exchange rate for the year the LIFO layer arose); less

(*2*) The amount of the LIFO layer liquidated during the taxable year, translated at the yearly average exchange rate for the taxable year.

(d) [Reserved]

(e) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the U.S. dollar as its functional currency. Except as otherwise indicated, U.S. Corp is the owner of Business A, a section 987 QBU with the euro as its functional currency, and U.S. Corp elects under paragraph (c)(2)(iv)(B) of this section to use the historic inventory method with respect to Business A but does not make any other elections.

(1) *Example 1: Item of income denominated in nonfunctional currency*. Business A accrues £100 of income from the provision of services. Under paragraph (b)(2) of this section, the £100 is translated into €90 at the spot rate on the date of accrual, without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €90 of income is translated into dollars at the yearly average exchange rate under paragraph (c)(1) of this section.

(2) *Example 2: Asset sold for nonfunctional currency.* Business A sells a historic asset consisting of non-inventory property for £100. Under paragraph (b)(2) of this section, the £100 amount realized is translated into €85 at the spot rate on the sale date without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €85 is translated into dollars at the yearly average exchange rate under paragraph (c)(1) of this section. The euro basis of the property is translated into dollars at the historic rate under paragraph (c)(2)(i) of this section.

(3) *Example 3: Historic inventory method*—(i) *Facts*. Business A uses a first-in, first-out (*FIFO*) method of accounting for inventory. Business A sells 1,200 units of inventory in year 2 for €3 per unit. The yearly average exchange rate is €1 = $1.02 for year 1 and €1 = $1.05 for year 2.

(ii) *Analysis*—(A) *Gross sales.* Business A's gross sales are translated under paragraph (c)(1) of this section at the yearly average exchange rate for the year of the sale. Business A's dollar gross sales will be computed as follows:

Table 1 to paragraph (e)(3)(ii)(A)
Gross Sales (year 2)

Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Jan	100	€ 300	€1 = $1.05	$315.00
Feb	200	600	€1 = $1.05	630.00
March	0	0	€1 = $1.05	0.00
April	200	600	€1 = $1.05	630.00
May	100	300	€1 = $1.05	315.00
June	0	0	€1 = $1.05	0.00
July	100	300	€1 = $1.05	315.00
Aug	100	300	€1 = $1.05	315.00
Sept	0	0	€1 = $1.05	0.00
Oct	0	0	€1 = $1.05	0.00
Nov	100	300	€1 = $1.05	315.00
Dec	300	900	€1 = $1.05	945.00
	1,200			$3,780.00

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

Table 2 to paragraph (e)(3)(ii)(B)
Opening Inventory and Purchases (year 2)

Month	*# of units*	*Amount in €*	*€/$ yearly average rate*	*Amount in $*
Opening inventory (purchased in Dec. year 1)				
	100	€150	€1 = $1.02	$153.00
Purchases in year 2				
Jan	300	€ 450	€1 = $1.05	$472.50
Feb	0	0	€1 = $1.05	0
March	0	0	€1 = $1.05	0
April	300	450	€1 = $1.05	472.50
May	0	0	€1 = $1.05	0
June	0	0	€1 = $1.05	0
July	300	450	€1 = $1.05	472.50
Aug	0	0	€1 = $1.05	0
Sept	0	0	€1 = $1.05	0
Oct	0	0	€1 = $1.05	0
Nov	300	450	€1 = $1.05	472.50
Dec	0	0	€1 = $1.05	0
	1,200			$1,890.00

(C) *COGS*. Because Business A uses a FIFO method for inventory, Business A is considered to have sold in year 2 the 100 units of opening inventory purchased in year 1 ($153.00), the 300 units purchased in January year 2 ($472.50), the 300 units purchased in April year 2 ($472.50), the 300 units purchased in July year 2 ($472.50), and 200 of the 300 units purchased in November year 2 ($315.00). Accordingly, Business A's translated dollar COGS for year 2 is $1,885.50. Business A's opening inventory for year 3 is 100 units of inventory with a translated dollar basis of $157.50.

(D) *Gross sales income*. Accordingly, for purposes of section 987, Business A has gross income in dollars of $1,894.50 ($3,780.00 - $1,885.50) from the sale of inventory in year 2.

(4) *Example 4: Simplified inventory method*—(i) *Facts*. The facts are the same as in paragraph (e)(3) of this section (*Example 3*), except that U.S. Corp does not elect to use the historic inventory method with respect to Business A.

(ii) *Analysis*. Because U.S. Corp does not elect to use the historic inventory method, the simplified inventory method under paragraph (c)(2)(iv)(A) of this section applies.

(A) *Gross sales*. Business A's dollar gross sales will be computed as described in paragraph (e)(3)(ii)(A) of this section (*Example 3*). Therefore, Business A has gross sales of $3,780.

(B) *COGS*. Business A sold 1,200 units of inventory in year 2, and the purchase price for each unit was €1.50. The total purchase price for the inventory sold in year 2 was €1,800. Under the simplified inventory method provided in paragraph (c)(2)(iv)

(A) of this section, COGS for a taxable year is translated into the functional currency of the owner at the yearly average exchange rate for the taxable year in which the sale of inventory occurs. Therefore, before making the adjustments required under paragraph (c)(3) of this section, Business A's dollar COGS for year 2 is equal to $1,890 (the purchase price for the inventory sold in year 2 (€1,800), translated at the yearly average exchange rate of €1 = $1.05).

(C) *Adjustments required*. Because the simplified inventory method applies, Business A's COGS must be adjusted under paragraph (c)(3) of this section. No adjustment is required under paragraph (c)(3)(ii) of this section because no cost recovery deduction attributable to a historic asset is included in inventoriable costs for year 2. However, an adjustment for beginning inventory is required under paragraph (c)(3)(iii)(A) of this section because Business A uses a FIFO method of accounting for inventory.

(D) *Adjustment for beginning inventory*. The adjustment required under paragraph (c)(3)(iii)(A) of this section is equal to: the ending non-LIFO inventory included on Business A's closing balance sheet for the preceding taxable year (€150), translated at the yearly average exchange rate for year 1 (€1 = $1.02), which is $153; less the ending non-LIFO inventory included on Business A's closing balance sheet for the preceding taxable year (€150), translated at the yearly average exchange rate for year 2 (€1 = $1.05), which is $157.50. Therefore, there is a negative adjustment to COGS of $4.50. Business A's COGS for year 2 is reduced from $1,890 to $1,885.50.

(E) *Gross sales income*. Accordingly, for purposes of section 987, Business A has gross income in dollars of $1,894.50 ($3,780.00 - $1,885.50) from the sale of inventory in year 2.

(5) *Example 5: Depreciation expense that is not an inventoriable cost.* The facts are the same as in paragraph (e)(3) of this section (*Example 3*) except that during year 2, Business A incurred €100 of depreciation expense with respect to a truck. No portion of the depreciation expense is an inventoriable cost. The truck was purchased on January 15, year 1. The yearly average exchange rate for year 1 was €1 = $1.02. Under paragraph (c)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic rate. The historic rate is the yearly average exchange rate for year 1. Accordingly, U.S. Corp takes into account depreciation of $102 with respect to Business A in year 2.

(6) *Example 6: Translation of depreciation expense that is an inventoriable cost (historic inventory method).* The facts are the same as in paragraph (e)(5) of this section (*Example 5*) except that the €100 of depreciation expense incurred during year 2 with respect to the truck is an inventoriable cost. As a result, the depreciation expense is capitalized into the 1,200 units of inventory purchased by Business A in year 2. Of those 1,200 units, 1,100 units are sold during the year, and 100 units become ending inventory. The portion of depreciation expense capitalized into inventory that is sold during year 2 is reflected in Business A's euro COGS and is translated at the €1 = $1.02 yearly average exchange rate for year 1, the year in which the truck was purchased. The portion of the depreciation expense capitalized into the 100 units of ending inventory is not taken into account in year 2 but rather, will be taken into account in the year the ending inventory is sold, translated at the €1 = $1.02 yearly average exchange rate for year 1.

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

(8) *Example 8: Current rate election*. The facts are the same as in paragraph (e)(7) of this section (*Example 7*), except that U.S. Corp makes a current rate election under §1.987-1(d)(2). Under paragraph (c)(2) of this section, the exceptions to paragraph (c)(1) of this section generally do not apply in a taxable year for which an annual recognition election or a current rate election is in effect. As a result, all items of income, gain, deduction, and loss with respect to Business A are translated into U.S Corp's functional currency at the yearly average exchange rate under paragraph (c)(1) of this section. Business A's gain on the sale of the land is determined in its functional currency and is equal to €2,000 (amount realized of €10,000 less basis of €8,000). This gain is translated at the yearly average exchange rate for year 2 of €1 = $1.05, and the amount of gain reported by U.S. Corp on the sale of the land is $2,100. The result would be the same if U.S. Corp made an annual recognition election under §1.987-5(b)(2) (and did not make a current rate election).

(9) through (12) [Reserved]

(13) *Example 13*: *Section 988 transaction*—(i) *Facts*. Business A receives and accrues $100 of income from the provision of services on January 1, 2021. Business A continues to hold the $100 as a U.S. dollar-denominated demand deposit at a bank on December 31, 2021. U.S. Corp has made a section 988 mark-to-market election under paragraph (b)(4)(ii) of this section. The euro-dollar spot rate without the use of a spot rate convention is €1 = $1 on January 1, 2021, and €1 = $2 on December 31, 2021, and the yearly average exchange rate for 2021 is €1 = $1.50.

(ii) *Analysis*—(A) Under paragraph (b)(2) of this section, the $100 earned by Business A is translated into €100 at the spot rate on January 1, 2021, as defined in §1.987-1(c)(1) without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €100 of services income is translated into $150 at the yearly average exchange rate for 2021, as provided in paragraph (c)(1) of this section.

(B) Under paragraph (b)(4)(i) of this section, section 988 gain or loss for Business A's section 988 transactions is determined in, and by reference to, the euro, the functional currency of Business A. Accordingly, section 988 gain or loss must be determined on Business A's holding of the $100 demand deposit in, and by reference to, the euro. Under §1.988-2(a)(2), Business A is treated as having an amount realized of €50 when the $100 is marked to market at the end of 2021 under paragraph (b)(4)(ii) of this section. Marking the dollars to market gives rise to a section 988 loss of €50 (€50 amount realized, less Business A's €100 basis in the $100). In determining U.S. Corp's taxable income, that €50 loss is translated into a $75 loss at the yearly average exchange rate for 2021, as provided in paragraph (c)(1) of this section.

(14) *Example 14: Payment of foreign income tax*—(i) *Facts*. Business A earns €100 of revenue from the provision of services and incurs €30 of general expenses and €10 of depreciation expense during 2021. Except as otherwise provided, U.S. Corp uses the yearly average exchange rate described in §1.987-1(c)(2) to translate items of income, gain, deduction, and loss of Business A. Business A is subject to income tax in Country X at a 25 percent rate. U.S. Corp claims a credit with respect to Business A's foreign income taxes and elects under section 986(a)(1)(D) to translate the foreign income taxes at the spot rate on the date the taxes were paid. The yearly average exchange rate for 2021 is €1 = $1.50. The historic rate used to translate the depreciation expense is €1 = $1.00. The spot rate on the date that Business A paid its foreign income taxes was €1 = $1.60.

(ii) *Analysis*. Because U.S. Corp has elected to translate foreign income taxes at the spot rate on the date such taxes were paid rather than at the yearly average exchange rate, U.S. Corp must make the adjustments described in paragraph (c)(2)(v) of this section. Accordingly, U.S. Corp determines its section 987 taxable income or loss by reducing the section 987 taxable income or loss that otherwise would be determined under this section by €15, translated into U.S. dollars at the yearly average exchange rate (€1 = $1.50), and increasing the resulting amount by €15, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a) (€1 = $1.60). Following these adjustments, Business A's section 987 taxable income for 2021 is $96.50, computed as follows:

Table 3 to paragraph (e)(14)(ii)

	Amount in €	*Translation Rate*	*Amount in $*
Revenue	€100	€1 = $1.50	$150.00
General Expenses	(30)	€1 = $1.50	(45.00)
Depreciation	(10)	€1 = $1.00	(10.00)
Tentative section 987 taxable income	€60		$95.00

Adjustments under paragraph (c)(2)(v) of this section:	
Decrease by €15 tax translated at yearly average exchange rate (€1 = $1.50)	($22.50)
ncrease by €15 tax translated at spot rate on payment date (€1 = $1.60)	24.00
Section 987 taxable income	$96.50

§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 is determined by the owner annually as provided in paragraph (b) of this section in the owner's functional currency. Only assets and liabilities attributable to the section 987 QBU are taken into account.

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

(1) The section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years 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 and §1.987-14.

(c) *Net accumulated unrecognized section 987 gain or loss for all prior taxable years*—(1) *In general*. A section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is the aggregate of the amounts determined under paragraph (d) of this section for all prior taxable years to which this section applies, reduced by amounts recognized under §1.987-5(a), amounts treated as deferred section 987 gain or loss, and amounts treated as suspended section 987 loss for all prior taxable years to which this section applies. Accordingly, net accumulated unrecognized section 987 gain or loss is not reduced under this paragraph (c)(1) when deferred section 987 gain or loss is recognized (or suspended) under §1.987-12 or when suspended section 987 loss is recognized under §1.987-11 or §1.987-13.

(2) *Additional adjustments for certain taxable years beginning on or before December 31, 2024*. For any section 987 QBU in existence before the transition date, *see* §1.987-10(e)(5) and (f)(2) for additional adjustments to the section 987 QBU's net accumulated unrecognized section 987 gain or loss.

(d) *Calculation of unrecognized section 987 gain or loss for a taxable year.* The unrecognized section 987 gain or loss of a section 987 QBU for a taxable year is generally determined under paragraphs (d)(1) through (10) of this section. However, for taxable years in which a current rate election or an annual recognition election is in effect, the unrecognized section 987 gain or loss of a section 987 QBU for a taxable year is determined by applying only paragraphs (d)(1) through (5) and (10) of this section. *See* §1.987-14 for additional adjustments that must be made to the unrecognized section 987 gain or loss of a section 987 QBU for a taxable year in connection with a section 987 hedging transaction.

(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 equals—

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

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

(ii) *Year section 987 QBU is terminated*. If a section 987 QBU is terminated within the meaning of §1.987-8 during an owner's taxable year, the termination date is treated as the last day of the taxable year for purposes of this section.

(iii) *First taxable year of a section 987 QBU*. If the owner's taxable year is the first taxable year of a section 987 QBU, the owner functional currency net value of the section 987 QBU described in paragraph (d)(1)(i)(B) of this section is zero.

(iv) *First year in which an election is in effect or ceases to be in effect*. Except as otherwise provided, the owner functional currency net value of the section 987 QBU described in paragraph (d)(1)(i)(B) of this section is determined based on the elections that were (or were not) in effect on the last day of the preceding taxable year.

(2) *Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner*—(i) *In general.* The amount determined in paragraph (d)(1) of this section is increased by the total amount of assets transferred from the section 987 QBU to the owner during the taxable year translated into the functional currency of the owner as provided in paragraph (d)(2)(ii) of this section.

(ii) *Assets transferred from the section 987 QBU to the owner during the taxable year*. The total amount of assets transferred from the section 987 QBU to the owner for the taxable year translated into the functional currency of the owner equals the sum of:

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

(B) The aggregate adjusted basis of all historic assets transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the historic rate for each such asset.

(3) *Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU*—(i) *In general*. The aggregate amount determined in paragraphs (d)(1) and (2) of this section is decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year deter-

mined in the functional currency of the owner as provided in paragraph (d)(3)(ii) of this section.

(ii) *Assets 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 equals the sum of:

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

(B) The aggregate adjusted basis of all other assets, after taking into account §1.988-1(a)(10), transferred to the section 987 QBU during the taxable year determined in the functional currency of the owner immediately before the transfer.

(4) *Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner*—(i) *In general*. The aggregate amount determined in paragraphs (d)(1) through (3) of this section is decreased by the total amount of liabilities transferred from the section 987 QBU to the owner during the taxable year translated into the functional currency of the owner as provided in paragraph (d)(4)(ii) of this section.

(ii) *Liabilities transferred from the section 987 QBU to the owner during the taxable year*. The total amount of liabilities transferred from the section 987 QBU to the owner for the taxable year equals the sum of:

(A) The amount of marked liabilities, after taking into account §1.988-1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the spot rate applicable to the date of transfer; and

(B) The amount of historic liabilities transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the functional currency of the owner at the historic rate for each such liability.

(5) *Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU*. The aggregate amount determined in paragraphs (d)(1) through (4) of this section is increased by the total amount of liabilities, after taking into account §1.988-1(a)(10), transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner immediately before the transfer.

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

(7) *Step 7: Increase the amount determined in steps 1 through 6 by certain expenses or losses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year*. The aggregate amount determined under paragraphs (d)(1) through (6) of this section is increased by the amount of any expense or loss that reduces the basis of assets or increases the amount of liabilities attributable to the section 987 QBU for the taxable year but is not deductible in computing the section 987 QBU's taxable income or loss for the taxable year (such as business interest expense that is not deductible under section 163(j)). Items of expense or loss described in the preceding sentence are translated into the functional currency of the owner using the exchange rate that would apply under §1.987-3(c) if they were deductible in computing the section 987 QBU's taxable income or loss for the taxable year. However, any foreign income taxes incurred by the section 987 QBU with respect to which the owner claims a credit are translated at the same rate at which such taxes were translated under section 986(a).

(8) *Step 8: Decrease the amount determined in steps 1 through 7 by the amount of certain income or gain that is not included in taxable income in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year*. The aggregate amount determined under paragraphs (d)(1) through (7) of this section is decreased by the amount of any income or gain that increases the basis of assets or reduces the amount of liabilities attributable to the section 987 QBU for the taxable year but is not included in taxable income in computing the section 987 QBU's taxable income or loss for the taxable year. Items of income or gain described in the preceding sentence are translated into the functional currency of the owner using the exchange rate that would apply under §1.987-3(c) if they were included in taxable income in computing the section 987 QBU's taxable income or loss for the taxable year.

(9) *Step 9: Increase or decrease the amount determined in steps 1 through 8 by any income or gain, or any deduction or loss, respectively, that does not impact the adjusted balance sheet*. The aggregate amount determined under paragraphs (d)(1) through (8) of this section is increased by any items of income or gain taken into account in paragraph (d)(6) of this section (step 6) that do not increase the basis of assets or reduce the amount of liabilities attributable to the section 987 QBU for the taxable year, and decreased by any items of deduction or loss taken into account in paragraph (d)(6) of this section (step 6) that do not reduce the basis of assets or increase the amount of liabilities attributable to the section 987 QBU for the taxable year. Items of income, gain, deduction, or loss described in the preceding sentence are translated into the functional currency of the owner using the exchange rate that applied under §1.987-3(c) in computing the section 987 QBU's taxable income or loss for the taxable year.

(10) *Step 10: Decrease or increase the amount determined in steps 1 through 9 by any increase or decrease, respectively, to the section 987 QBU's net assets that is not previously taken into account under steps 2 through 9*—(i) *In general*. Except as provided in paragraph (d)(10)(iii) of this section, the aggregate amount determined under paragraphs (d)(1) through (9) of this section is—

(A) Decreased by the residual increase to net assets (as defined in paragraph (d)(10)(ii) of this section), translated into the owner's functional currency at the yearly average exchange rate for the taxable year; or

(B) Increased by the residual decrease to net assets (as defined in paragraph (d)(10)(ii) of this section), translated into the owner's functional currency at the yearly average exchange rate for the taxable year.

(ii) *Determining the residual increase or decrease to net assets*—(A) *In general*. The residual increase to net assets is the positive amount, if any, that would be determined under paragraphs (d)(1) through (9) of this section in the functional currency of the section 987 QBU if such amounts were determined in the functional currency of the section 987 QBU. The residual decrease to net assets is the negative amount, if any, that would be determined under paragraphs (d)(1) through (9) of this section in the functional currency of the section 987 QBU if such amounts were determined in the functional currency of the section 987 QBU.

(B) *Application of step 1 in the functional currency of the section 987 QBU if a current rate election is in effect*. In a taxable year in which a current rate election is in effect, for purposes of applying step 1 (paragraph (d)(1) of this section) in the functional currency of the section 987 QBU, the change in the net value of the section 987 QBU is determined by reference to the QBU net value described in paragraph (e)(2)(ii) of this section.

(C) *Application of steps 3 and 5 in the functional currency of the section 987 QBU*. For purposes of applying steps 3 and 5 (paragraphs (d)(3) and (5) of this section) in the functional currency of the section 987 QBU, the amount of assets and liabilities transferred from an owner to a section 987 QBU is determined by translating the basis of the assets and the amount of the liabilities under §1.987-2(d).

(iii) *Modifications for taxable years to which a current rate election or an annual recognition election applies*. For any taxable year to which a current rate election or an annual recognition election applies, paragraphs (d)(10)(i) and (ii) of this section are applied by replacing "paragraphs (d)(1) through (9) of this section" with "paragraphs (d)(1) through (5) of this section."

(e) *Determination of the owner functional currency net value of a section 987 QBU*—(1) *In general*. Except as provided in paragraph (e)(2) of this section, the owner functional currency net value of a section 987 QBU on the last day of a taxable year is equal to the aggregate amount of functional currency and the adjusted basis of each other asset on the section 987 QBU's adjusted balance sheet on that day, less the aggregate amount of each liability on the section 987 QBU's adjusted balance sheet on that day, in each case translated into the owner's functional currency as provided in paragraphs (e)(1)(i) and (ii) of this section.

(i) *Marked item*. A marked item is translated into the owner's functional currency at the spot rate applicable to the last day of the relevant taxable year.

(ii) *Historic item*. A historic item is translated into the owner's functional currency at the historic rate.

(2) *Current rate election*—(i) *In general*. If a current rate election is in effect, the owner functional currency net value of a section 987 QBU on the last day of a taxable year is equal to the QBU net value described in paragraph (e)(2)(ii) of this section, translated into the owner's functional currency at the spot rate applicable to that day.

(ii) *QBU net value*. The QBU net value of a section 987 QBU on the last day of a taxable year is determined in the functional currency of the section 987 QBU and is equal to the aggregate amount of functional currency and the adjusted basis of each other asset that is attributable to the section 987 QBU on that day, less the aggregate amount of each liability that is attributable to the section 987 QBU on that day. The QBU net value of a section 987 QBU on the last day of a taxable year may be determined either by preparing an adjusted balance sheet or by following the steps described in paragraph (e)(2)(iii) of this section (provided that the calculation is made consistently for all years in which a current rate election is in effect). However, in the first taxable year in which a current rate election ceases to be in effect, the owner functional currency net value of the section 987 QBU for the preceding taxable year must be determined by preparing an adjusted balance sheet.

(iii) *Alternative calculation of QBU net value*. The QBU net value of a section 987 QBU on the last day of a taxable year can be computed using the following steps (each applied in the functional currency of the section 987 QBU). *See* paragraph (g)(2)(iii) of this section (*Example 2*) for an example illustrating this rule.

(A) *Step 1: Determine the QBU net value on the last day of the preceding taxable year*. Determine the QBU net value on the last day of the preceding taxable year under this paragraph (e)(2). If the owner's taxable year is the first taxable year of a section 987 QBU, the QBU net value on the last day of the preceding taxable year is zero. In the first taxable year in which a current rate election is in effect (other than the taxable year beginning on the transition date or the first taxable year of a section 987 QBU), the QBU net value on the last day of the preceding taxable year is determined by preparing an adjusted balance sheet. In the taxable year beginning on the transition date (other than the first taxable year of a section 987 QBU), the QBU net value on the last day of the preceding taxable year may be determined either by preparing an adjusted balance sheet or by applying the steps described in this paragraph (e)(2)(iii) for each taxable year beginning with the first taxable year of the section 987 QBU.

(B) *Step 2: Adjust for transfers between the section 987 QBU and its owner*. The amount determined in paragraph (e)(2)(iii)(A) of this section is increased by the amount of each transfer described in paragraph (d)(3) or (4) of this section and decreased by the amount of each transfer described in paragraph (d)(2) or (5) of this section (in each case, after adjustment for gain or loss recognized under §1.988-1(a)(10)). For this purpose, the amount of assets and liabilities transferred from an owner to a section 987 QBU is determined by translating the basis of the assets and the amount of the liabilities under §1.987-2(d)(1).

(C) *Step 3: Adjust for income or loss of the section 987 QBU*. The amount determined in paragraph (e)(2)(iii)(B) of this section is increased by items of income and gain attributable to the section 987 QBU (including tax-exempt income described in paragraph (d)(8) of this section) for the taxable year and reduced by items of deduction and loss attributable to the section 987 QBU (including non-deductible expenses described in paragraph (d)(7) of this section) for the taxable year. However, no adjustment is made under the preceding sentence for any item of income, gain, deduction, or loss described in paragraph (d)(9) of this section.

(f) *Combinations and separations*—(1) *Combinations*. The net accumulated unrecognized section 987 gain or loss of a combined QBU for a taxable year is equal to the sum of the combining QBUs' net accumulated unrecognized section 987 gain or loss. *See* paragraph (f)(3)(i) of this section (*Example 1*) for an illustration of this rule.

(2) *Separations*. The net accumulated unrecognized section 987 gain or loss of a separated QBU for a taxable year is equal to the separating QBU's net accumulated unrecognized section 987 gain or loss multiplied by the separation fraction. For purposes of determining the owner functional currency net value and QBU net value of the separated QBUs on the last day of the taxable year preceding the taxable year of separation under paragraphs (d)(1)(i)(B) and (e) of this section, the assets and liabilities attributable to the separating QBU on that day are deemed to be attributable to the separated QBUs on that day, and are apportioned between the separated QBUs in a reasonable manner that takes into account the assets and liabilities attributable to the separated QBUs immediately after the separation. *See* paragraph (f)(3)(ii) of this section (*Example 2*) for an illustration of this rule.

(3) *Examples*. The following examples illustrate the rules of paragraphs (f)(1) and (2) of this section. For purposes of these examples, assume that no section 987 elections are in effect.

(i) *Example 1: Combination of two section 987 QBUs that have the same owner*—(A) *Facts*. DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a manufacturing business that constitutes a section 987 QBU (*Manufacturing QBU*) that has the euro as its functional currency. Manufacturing QBU has a net accumulated unrecognized section 987 loss of $100. DC1 also owns Entity B, a DE. Entity B conducts a sales business that constitutes a section 987 QBU (*Sales QBU*) that has the euro as its functional currency. Sales QBU has a net accumulated unrecognized section 987 gain of $110. During the taxable year, Entity A merges into Entity B under local law pursuant to which Entity A ceases to exist, Entity B survives, and Entity B acquires all the assets and liabilities of Entity A. As a result, the books and records of Manufacturing QBU and Sales QBU are combined into a new single set of books and records. The combined entity has the euro as its functional currency.

(B) *Analysis*. Pursuant to §1.987-2(c)(9)(i), Manufacturing QBU and Sales QBU are combining QBUs, and their combination does not give rise to a transfer that is taken into account in determining the amount of a remittance (as defined in §1.987-5(c)). For purposes of computing net unrecognized section 987 gain or loss under this section for the year of the combination, the combination is deemed to have occurred on the last day of the owner's prior taxable year, such that the owner functional currency net value of the combined section 987 QBU at the end of that taxable year described under paragraph (d)(1)(i)(B) of this section takes into account items attributable to both Manufacturing QBU and Sales QBU at that time. Additionally, any transactions between Manufacturing QBU and Sales QBU occurring during the year of the merger will not result in transfers to or from a section 987 QBU. Pursuant to paragraph (f)(1) of this section, the combined QBU will have a net accumulated unrecognized section 987 gain of $10 (the $100 loss from Manufacturing QBU plus the $110 gain from Sales QBU).

(ii) *Example 2: Separation of two section 987 QBUs that have the same owner*—(A) *Facts*. DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in the Netherlands that constitutes a section 987 QBU (*Dutch QBU*) that has the euro as its functional currency. The business of Dutch QBU consists of manufacturing and selling bicycles and scooters and is recorded on a single set of books and records. On the last day of year 1, the adjusted basis of the gross assets of Dutch QBU is €1,000. In year 2, the net accumulated unrecognized section 987 loss of Dutch QBU from all prior taxable years is $200. During year 2, Entity A separates the bicycle and scooter business such that each business begins to have its own books and records and to meet the definition of a section 987 QBU under §1.987-1(b)(3) (hereafter, "bicycle QBU" and "scooter QBU"). There are no transfers between DC1 and Dutch QBU before the separation. After the separation, the aggregate adjusted basis of bicycle QBU's assets is €600 and the aggregate adjusted basis of scooter QBU's assets is €400. Each section 987 QBU continues to have the euro as its functional currency.

(B) *Analysis*. Pursuant to §1.987-2(c)(9)(iii), bicycle QBU and scooter QBU are separated QBUs, and the separation of Dutch QBU, a separating QBU, does not give rise to a transfer taken into account in determining the amount of a remittance. For purposes of computing net unrecognized section 987 gain or loss under this section for year 2, the separation will be deemed to have occurred on the last day of the owner's prior taxable year, year 1. Pursuant to paragraph (f)(2) of this section and §1.987-1(h), bicycle QBU will have a separation fraction of €600/€1,000 and net accumulated unrecognized section 987 loss of $120 (€600/€1,000 x $200), and scooter QBU will have a separation fraction of €400/€1,000 and net accumulated unrecognized section 987 loss of $80 (€400/€1,000 x $200).

(g) *Examples*. The following examples illustrate the provisions of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the dollar as its functional currency. Except as otherwise indicated, no section 987 elections are in effect. The examples are not intended to demonstrate when activities constitute a trade or business within the meaning of §1.989(a)-1(b)(2)(ii)(A) and (c) and therefore whether a section 987 QBU is considered to exist.

(1) *Example 1: Determination of net unrecognized section 987 gain or loss*—(i) *Facts*. On July 1, year 1, U.S. Corp establishes Japan Branch, a section 987 QBU that has the yen as its functional currency, and U.S. Corp transfers to Japan Branch ¥100,000 with a basis of $1,000 and raw land with a basis of $500. On the same day, Japan Branch borrows ¥10,000 from a bank. In year 1, Japan Branch earns ¥12,000 for providing services and incurs ¥2,000 of related expenses. Japan Branch thus earns ¥10,000 of net income in year 1. The spot rate on July 1, year 1, is $1 = ¥100; the spot rate on December 31, year 1, is $1 = ¥120; and the average rate for the period of July 1, year 1, to December 31, year 1, is $1 = ¥110. Thus, the ¥12,000 of services revenue when translated under §1.987-3(c)(1) at the yearly average exchange rate equals $109.09 (¥12,000 x ($1 / ¥110)) = $109.09). The ¥2,000 of expenses translated at the same yearly average exchange rate equals $18.18 (¥2,000 x ($1 / ¥110) = $18.18). Thus, Japan Branch's net income translated into dollars equals $90.91 ($109.09 - $18.18 = $90.91).

(ii) *Analysis*. Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for year 1. Because this is Japan Branch's first taxable year, the net unrecognized section 987 gain or loss (as defined under paragraph (b) of this section) is equal to the branch's unrecognized section 987 gain or loss for year 1 as determined in paragraph (d) of this section. The calculations under paragraph (d) of this section are made as follows:

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

(*1*) The OFCNV of Japan Branch on December 31, year 1 is determined under paragraph (e) of this section as the sum of the basis of each asset on Japan Branch's adjusted balance sheet on December 31, year 1, less the sum of each liability on Japan Branch's adjusted balance sheet on that date, translated into dollars as provided in paragraphs (e)(1)(i) and (ii) of this section.

(*2*) For this purpose, Japan Branch will show the following assets and liabilities on its adjusted balance sheet for December 31, year 1: cash of ¥120,000; raw land with a basis of ¥55,000 ($500 translated under §1.987-2(d)(2) at the historic rate of $1 = ¥110); and liabilities of ¥10,000.

(*3*) Under paragraphs (e)(1)(i) and (ii) of this section, U.S. Corp will translate these items as follows. The ¥120,000 is a marked asset and the ¥10,000 liability is a marked liability. These items are translated into dollars on December 31, year 1, using the spot rate on December 31, year 1, of $1 = ¥120. The raw land is a historic asset and is translated into dollars under paragraph (e)(1)(ii) of this section at the historic rate, which under §1.987-1(c)(3)(i)(A) is the yearly average exchange rate of $1 = ¥110 applicable to the year the land was transferred to the QBU.

(*4*) The OFCNV of Japan Branch on December 31, year 1, in dollars is $1,416.67. The determination of the OFCNV of Japan Branch on December 31, year 1, is shown below in dollars together with the corresponding amounts in yen.

Table 1 to paragraph (g)(1)(ii)(A)(*4*)
OFCNV—End of Year 1

Assets	*Amount in ¥*	*Translation Rate*	*Amount in $*
Yen	¥120,000	$1 = ¥120 (spot rate-12/31/year 1)	$1,000.00
Land	¥55,000	$1 = ¥110 (historic rate-yearly average rate-year 1)	$500.00
Total assets	¥175,000		$1,500.00
Liabilities			
Bank loan	¥10,000	$1 = ¥120 (spot rate-12/31/year 1)	$83.33
Total liabilities	¥10,000		$83.33
Year 1 ending net value	¥165,000		$1,416.67

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

(B) *Step 2 (no adjustment)*. No adjustment is made under paragraph (d)(2) of this section (step 2) because no assets were transferred by Japan Branch to U.S. Corp during the taxable year.

(C) *Step 3*. On July 1, year 1, U.S. Corp transferred to Japan Branch ¥100,000 with a basis of $1,000.00 and raw land with a basis of $500.00 (equal to ¥55,000, translated under §1.987-2(d)(2) at the historic rate of $1 = ¥110). The total amount of assets transferred from U.S. Corp to Japan Branch in dollars is $1,500, and the total amount of the transfer in yen is ¥155,000. Therefore, under paragraph (d)(3) of this section (step 3), the amount determined in previous steps is reduced by $1,500.00, from $1,416.67 to negative $83.33.

(D) *Steps 4 and 5 (no adjustment)*. No adjustment is made under paragraphs (d)(4) and (5) of this section (steps 4 and 5) because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year.

(E) *Step 6*. Under paragraph (d)(6) of this section (step 6), the amount determined in previous steps is decreased by the section 987 taxable income of Japan Branch of $90.91, from negative $83.33 to negative $174.24.

(F) *Steps 7 through 9 (no adjustment)*. No adjustment is made under paragraphs (d)(7) through (9) of this section (steps 7 through 9) because all of Japan Branch's items of income or deduction for the taxable year impact the basis of Japan Branch's assets or the amount of its liabilities and are taken into account in computing taxable income.

(G) *Step 10 (no adjustment)—*(*1*) *Calculation of residual increase or decrease to net assets*. Under paragraph (d)(10)(ii) of this section, the residual increase (or decrease) to net assets is the positive (or negative) amount, if any, that would be determined under paragraphs (d)(1) through (9) of this section (steps 1 through 9) in the functional currency of the section 987 QBU if such amounts were determined in the functional currency of the section 987 QBU. In year 1, the relevant steps that must be applied in the functional currency of Japan Branch (the yen) are paragraphs (d)(1), (3), and (6) of this section (steps 1, 3, and 6). For purposes of applying paragraph (d)(1) of this section (step 1) in yen, the change in the net value of Japan Branch is ¥165,000. *See* paragraph (g)(1)(ii)(A)(*4*) of this section. For purposes of applying paragraph (d)(3) of this section (step 3) in yen, the amount of assets transferred from U.S. Corp to Japan Branch is ¥155,000. *See* paragraph (g)(1)(ii)(C) of this section. For purposes of applying paragraph (d)(6) of this section (step 6) in yen, Japan Branch earned ¥10,000 of net income in year 1. The application of these steps results in no residual increase or decrease to the adjusted balance sheet, as shown below:

Table 2 to paragraph (g)(1)(ii)(G)(*1*)
Application of Relevant Steps in Yen

Change in net value in yen (step 1)	¥165,000
Subtract amount determined in yen under step 3 (transfers from owner to section 987 QBU)	(¥155,000)
Subtract amount determined in yen under step 6 (section 987 taxable income or loss)	(¥10,000)
Residual increase or decrease to the adjusted balance sheet	¥0

(*2*) *No residual increase or decrease to the adjusted balance sheet*. As explained in paragraph (g)(1)(ii)(G)(*1*) of this section, there is no residual increase or decrease to the adjusted balance sheet of Japan Branch in year 1. Therefore, no adjustment is made under paragraph (d)(10) of this section (step 10). Accordingly, the unrecognized section 987 loss of Japan Branch for year 1 is $174.24.

(2) *Example 2: Determination of net unrecognized section 987 gain or loss if a current rate election is in effect*—(i) *Facts*. The facts are the same as in paragraph (g)(1) of this section (*Example 1*), except that U.S. Corp makes a current rate election under §1.987-1(d)(2) for year 1.

(ii) *Analysis*. Because a current rate election is in effect for year 1, the unrecognized section 987 gain or loss for year 1 is determined by applying only paragraphs (d)(1) through (5) and (10) of this section (steps 1 through 5 and step 10). The calculations under paragraph (d) of this section are made as follows:

(A) *Step 1*. The change in the OFCNV of Japan Branch for year 1 is equal to the OFCNV of Japan Branch determined in dollars on the last day of year 1, less the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year.

(*1*) For this purpose, Japan Branch will show the same assets and liabilities on its adjusted balance sheet for December 31, year 1 as are described in paragraph (g)(1)(ii)(A)(*2*) of this section (*Example 1*), but the land is treated as a marked asset as a result of the current rate election. The adjusted balance sheet reflects cash of ¥120,000, raw land with a basis of ¥50,000 ($500 translated under §1.987-2(d)(1) at the July 1, year 1 spot rate of $1 = ¥100), and liabilities of ¥10,000.

(*2*) Under paragraph (e)(2)(ii) of this section, because a current rate election is in effect, the OFCNV of Japan Branch at the end of year 1 is equal to the QBU net value, translated into U.S. dollars at the applicable spot rate on the last day of the taxable year. The QBU net value of Japan Branch at the end of year 1 is ¥160,000, as shown below. The OFCNV of Japan Branch is $1,333.33, which is equal to the QBU net value of ¥160,000, translated at the applicable spot rate on December 31, year 1 of $1 = ¥120.

Table 3 to paragraph (g)(2)(ii)(A)(*2*)
QBU Net Value—Year 1

Assets	*Amount in ¥*
Yen	¥120,000
Land	¥50,000
Total assets	¥170,000
Liabilities	
Bank loan	¥10,000
Total liabilities	¥10,000
Year 1 QBU net value	¥160,000

(*3*) Under paragraph (d)(1) of this section, the change in OFCNV of Japan Branch for year 1 is equal to the OFCNV of the branch determined in dollars on December 31, year 1, (which is $1,333.33) less the OFCNV of the branch determined in dollars on the last day of the preceding taxable year. Because this is the first taxable year of Japan Branch, the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year is zero under paragraph (d)(1)(iii) of this section. Accordingly, the change in OFCNV of Japan Branch for year 1 is $1,333.33.

(B) *Step 2 (no adjustment)*. No adjustment is made under paragraph (d)(2) of this section (step 2) because no assets were transferred by Japan Branch to U.S. Corp during the taxable year.

(C) *Step 3.* On July 1, year 1, U.S. Corp transferred to Japan Branch ¥100,000 with a basis of $1,000.00 and raw land with a basis of $500.00 (equal to ¥50,000, translated under §1.987-2(d)(1) at the spot rate on July 31, year 1 of $1 = ¥100). The total amount of assets transferred in dollars is $1,500.00, and the amount of assets transferred in yen is ¥150,000. Therefore, under paragraph (d)(3) of this section (step 3), the amount determined in previous steps is reduced by $1,500, from $1,333.33 to negative $166.67.

(D) *Steps 4 and 5 (no adjustment*). No adjustment is made under paragraphs (d)(4) and (5) of this section (steps 4 and 5) because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year.

(E) *Steps 6 through 9 do not apply*. Under paragraph (d) of this section, paragraphs (d)(6) through (9) of this section (steps 6 through 9) do not apply because a current rate election is in effect.

(F) *Step 10*—(*1*) *Application of relevant steps in Japan Branch's functional currency*. Under paragraph (d)(10)(iii) of this section, because a current rate election is in effect, the residual increase or decrease to net assets is determined by applying paragraphs (d)(1) through (5) of this section (steps 1 through 5) in the functional currency of the section 987 QBU. The relevant steps that must be applied under paragraph (d)(10) of this section in the functional currency of Japan Branch are paragraphs (d)(1) and (3) of this section (steps 1 and 3). Under paragraph (d)(10)(ii)(B) of this section, step 1 is applied by reference to Japan Branch's QBU net value. *See* paragraphs (g)(2)(ii)(A) and (C) of this section for amounts determined in yen. The residual increase to net assets is determined as follows:

Table 4 to paragraph (g)(2)(ii)(F)(*1*)
Application of Relevant Steps in Yen

Step 1: Change in net value	¥160,000
Step 3: Subtract amount of transfers from owner to section 987 QBU	(¥150,000)
Residual increase or decrease to the adjusted balance sheet	¥10,000

(*2*) *Residual increase or decrease to net assets*. As explained in paragraph (g)(2)(ii)(F)(*1*) of this section, the residual increase to Japan Branch's net assets in year 1 is ¥10,000. This amount, translated at the yearly average exchange rate of $1 = ¥110, equals $90.91. Therefore, the amount determined in previous steps is reduced by $90.91, from negative $166.67 to negative $257.58. Accordingly, the unrecognized section 987 loss of Japan Branch for year 1 is $257.58.

(iii) *Alternative computation of QBU net value*. Alternatively, for purposes of applying steps 1 and 10 (paragraphs (d)(1) and (10) of this section), U.S. Corp can determine QBU net value using the following steps under paragraph (e)(2)(iii) of this section.

(A) *Step 1: Determine QBU net value at the end of the preceding taxable year*. Because year 1 is the first taxable year in which Japan Branch exists, the QBU net value at the end of the preceding taxable year is zero.

(B) *Step 2: Adjust for transfers between the section 987 QBU and its owner*. During year 1, U.S. Corp transferred assets to Japan Branch with an aggregate basis of ¥150,000, as described in paragraph (g)(2)(ii)(C) of this section. Therefore, the amount determined in step 1 is increased from zero to ¥150,000.

(C) *Step 3: Adjust for income or loss of the section 987 QBU*. During year 1, Japan Branch earned ¥10,000 of net income. Therefore, the amount determined in step 2 is increased from ¥150,000 to ¥160,000.

(D) *QBU net value*. Japan Branch's QBU net value at the end of the preceding taxable year is zero. This amount is increased by the transfer from U.S. Corp of ¥150,000 and by Japan Branch's taxable income of ¥10,000. Japan Branch did not have any tax-exempt income or non-deductible expenses in year 1. Accordingly, Japan Branch's QBU net value at the end of year 1 is ¥160,000.

(3) *Example 3: Determination of net unrecognized section 987 gain or loss when a current rate election is revoked*—(i) *Facts*—(A) *Background*. The facts in year 1 are the same as in paragraph (g)(2) of this section (*Example 2*). In year 9, a current rate election remains in effect, U.S. Corp has net unrecognized section 987 loss of $1,000 with respect to Japan Branch, and Japan Branch does not make a remittance. On December 31, year 9, the adjusted balance sheet of Japan Branch shows the following assets and liabilities: cash of ¥120,000; raw land with a basis of ¥50,000; and liabilities of ¥10,000. Effective for year 10, U.S. Corp revokes the current rate election.

(B) *Operations in year 10.* In year 10, Japan Branch earns ¥12,000 for providing services and incurs ¥2,000 of related expenses. Japan Branch thus earns ¥10,000 of net income in year 10. On December 31, year 10, the adjusted balance sheet of Japan Branch shows the following assets and liabilities: cash of ¥130,000; raw land with a basis of ¥50,000; and liabilities of ¥10,000. Assume that the spot rate on December 31, year 9, is $1 = ¥120; the spot rate on December 31, year 10, is $1 = ¥130; and the yearly average exchange rate for year 10 is $1 = ¥125. Thus, the ¥12,000 of services revenue when properly translated under §1.987-3(c)(1) at the yearly average exchange rate equals $96.00 (¥12,000 × ($1/¥125)) = $96.00). The ¥2,000 of expenses translated at the same yearly average exchange rate equals $16.00 (¥2,000 × ($1/¥125) = $16.00). Thus, Japan Branch's net income translated into dollars equals $80. There are no transfers of assets or liabilities between U.S. Corp and Japan Branch in year 10.

(ii) *Analysis*—(A) *Determination of OFCNV for year 9*. Under paragraph (d)(1)(iv) of this section, the OFCNV of a section 987 QBU on the last day of the preceding taxable year is determined based on the elections that were (or were not) in effect on the last day of that taxable year. In year 9, a current rate election was in effect. Therefore, in determining the OFCNV of Japan Branch for year 9, all assets and liabilities of Japan Branch (including the land) are treated as marked items. Under paragraph (e)(2)(ii) of this section, because a current rate election was in effect for year 9, the OFCNV of Japan Branch at the end of year 9 is equal to the QBU net value, translated into U.S. dollars at the applicable spot rate on the last day of the taxable year. The QBU net value of Japan Branch at the end of year 9 is ¥160,000, as shown below. The OFCNV of Japan Branch is $1,333.33, which is equal to the QBU net value of ¥160,000, translated at the applicable spot rate on December 31, year 9 of $1 = ¥120.

Table 5 to paragraph (g)(3)(ii)(A)
QBU Net Value - End of Year 9

Assets	*Amount in ¥*
Yen	¥120,000
Land	¥50,000
Total assets	¥170,000
Liabilities	
Bank loan	¥10,000
Total liabilities	¥10,000
Year 9 ending net value	¥160,000

(B) *Determination of OFCNV for year 10*. In year 10, a current rate election is not in effect. Therefore, in determining the OFCNV of Japan Branch for year 10, the land owned by Japan Branch is treated as a historic item. Under §1.987-1(c)(3)(i)(E), the historic rate applicable to historic items that were attributable to Japan Branch on the last day of the last taxable year in which a current rate election was in effect (December 31, year 9) generally is equal to the spot rate applicable to that day. Therefore, the historic rate applicable to the land is the spot rate on December 31, year 9. The OFCNV of Japan Branch for year 10 is $1,339.74, determined under paragraph (e) of this section as follows (together with the corresponding amounts in yen):

Table 6 to paragraph (g)(3)(ii)(B)
OFCNV—End of Year 10

Assets	*Amount in ¥*	*Translation Rate*	*Amount in $*
Yen	¥130,000	$1 = ¥130 (spot rate-12/31/year 10)	$1,000.00
Land	¥50,000	$1 = ¥120 (historic rate-spot rate-12/31/year 9)	$416.67
Total assets	¥180,000		$1,416.67
Liabilities			
Bank loan	¥10,000	$1 = ¥130 (spot rate-12/31/year 10)	$76.92
Total liabilities	¥10,000		$76.92
Year 10 ending net value	¥170,000		$1,339.74

(C) *Determination of unrecognized section 987 gain or loss for year 10*. The unrecognized section 987 gain or loss of Japan Branch for year 10 is determined under paragraph (d) of this section as follows:

(*1*) *Step 1.* The change in the OFCNV of Japan Branch for year 10 is equal to the OFCNV of Japan Branch determined in dollars on the last day of year 10, less the OFCNV of Japan Branch determined in dollars on the last day of year 9. Therefore, the change in OFCNV is equal to $6.41 ($1,339.74 - $1,333.33).

(*2*) *Steps 2 through 5 (no adjustment)*. No adjustment is made under paragraphs (d)(2) through (5) of this section (steps 2 through 5) because no assets or liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year.

(*3*) *Step 6.* Under paragraph (d)(6) of this section (step 6), the amount determined in previous steps is decreased by the section 987 taxable income of Japan Branch of $80.00, from $6.41 to negative $73.59.

(*4*) *Steps 7 through 10 (no adjustment)*. No adjustment is made under paragraphs (d)(7) through (10) of this section (steps 7 through 10) because all of Japan Branch's items of income or deduction for the taxable year impact the basis of Japan Branch's assets or the amount of its liabilities and are taken into account in computing taxable income. In addition, Japan Branch does not have a residual increase or decrease to net assets (because the change in net value of ¥10,000 is equal to the amount of Japan Branch's net income in year 10). Accordingly, the unrecognized section 987 loss of Japan Branch for year 10 is negative $73.59.

(D) *Determination of net unrecognized section 987 gain or loss*. In year 10, Japan Branch has net accumulated section 987 loss of $1,000. Because U.S. Corp revoked the current rate election for year 10, the net accumulated section 987 loss of $1,000 becomes suspended section 987 loss under §1.987-11(d)(2) and Japan Branch's net accumulated section 987 loss is reduced to zero. Therefore, in year 10, Japan Branch's net unrecognized section 987 loss is equal to $73.59, its unrecognized section 987 loss for year 10.

§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 includes the owner's section 987 gain or loss recognized with respect to the section 987 QBU for the taxable year. Except as otherwise provided in the section 987 regulations (including §1.987-11(c), §1.987-12(b) or (e), or §1.987-13(h) or (k)), for any taxable year the owner's section 987 gain or loss recognized with respect to a section 987 QBU is equal to:

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

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

(b) *Remittance proportion*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, the owner's remittance proportion with respect to a section 987 QBU for a taxable year is equal to:

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

(ii) The sum of:

(A) The aggregate adjusted basis of the gross assets that are attributable to the section 987 QBU as of the end of the taxable year, determined in the functional currency of the section 987 QBU; and

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

(2) *Annual recognition election*. A taxpayer may elect to recognize its net unrecognized section 987 gain or loss with respect to the section 987 QBU on an annual basis (*annual recognition election*). For any taxable year in which the annual recognition election is in effect, the owner's remittance proportion with respect to a section 987 QBU is one. *See* paragraph (g) of this section for an example illustrating this rule. Additionally, for any taxable year of an original deferral QBU owner in which an annual recognition election is in effect, the remittance proportion with respect to any successor deferral QBU is one.

(c) *Remittance*—(1) *Definition*. A remittance is determined in the section 987 QBU's functional currency and equals the excess, if any, of:

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

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

(2) *Alternative calculation*. The amount of a remittance described in paragraph (c)(1) of this section may alternatively be determined under the following steps (each applied in the functional currency of the section 987 QBU). If the amount determined under this paragraph (c)(2) is negative, the amount of the remittance is zero.

(i) *Step 1: Determine the change in QBU net value*. The change in QBU net value is equal to the QBU net value on the date provided in paragraph (c)(3) of this section, less the QBU net value on the last day of the preceding taxable year. In the first taxable year in which the section 987 QBU exists, the QBU net value on the last day of the preceding taxable year is zero.

(ii) *Step 2: Adjust the amount determined in step 1 for income or loss of the section 987 QBU*. The amount determined in paragraph (c)(2)(i) of this section is reduced (including below zero) by items of income and gain attributable to the section 987 QBU (including tax-exempt income described in §1.987-4(d)(8)) for the taxable year and increased by items of deduction and loss attributable to the section 987 QBU (including non-deductible expenses described in §1.987-4(d)(7)) for the taxable year. However, no adjustment is made under the preceding sentence for any item of income, gain, deduction, or loss described in §1.987-4(d)(9) (items that do not impact the adjusted balance sheet).

(iii) *Step 3: Multiply the amount determined in step 2 by negative one*. The amount of a remittance is equal to the amount determined in paragraph (c)(2)(ii) of this section multiplied by negative one.

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

(4) *Termination*. A termination of a section 987 QBU as determined under §1.987-8 is treated as a remittance of all the gross assets of the section 987 QBU to the owner on the date of such termination. *See* §1.987-8(e). Accordingly, for purposes of paragraph (b) of this section, the remittance proportion in the case of a termination is one.

(d) *Aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year*. For purposes of paragraph (c)(1)(i) of this section, the aggregate of all amounts transferred from the section 987 QBU to the owner for the taxable year is the aggregate amount of functional currency and the aggregate adjusted basis of the other assets transferred (after taking into account §1.988-1(a)(10)), determined in the section 987 QBU's functional currency. Solely for this purpose, the amount of liabilities transferred from the owner to the section 987 QBU (determined in the section 987 QBU's functional currency under §1.987-2(d) after taking into account §1.988-1(a)(10)) is treated as a transfer of assets from the section 987 QBU to the owner with an adjusted basis equal to the amount of such liabilities.

(e) *Aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year*. For purposes of paragraph (c)(1)(ii) of this section, the aggregate of all amounts transferred from the owner to the section 987 QBU for the taxable year is the aggregate amount of functional currency and the aggregate adjusted basis of the assets transferred (determined in the section 987 QBU's functional currency under §1.987-2(d) after taking into account §1.988-1(a)(10)). Solely for this purpose, the amount of liabilities transferred from the section 987 QBU to the owner (determined in the section 987 QBU's functional currency after taking into account §1.988-1(a)(10)) is treated as a transfer of assets from the owner to the section 987 QBU with an adjusted basis equal to the amount of such liabilities.

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

(2) *Marked items*. The basis of a marked asset or amount of a marked liability is the amount determined by translating the section 987 QBU's functional currency basis of the asset or amount of the liability, after taking into account §1.988-1(a)(10), into the owner's functional currency at the spot rate applicable to the date of transfer.

(3) *Historic items*. The basis of a historic asset or amount of a historic liability is the amount determined by translating the section 987 QBU's functional currency basis of the asset or amount of the liability into the owner's functional currency at the historic rate for the asset or liability.

(g) *Example—Calculation of section 987 gain or loss recognized.* The following example illustrates the calculation of section 987 gain or loss under this section. For purposes of this example, except as otherwise indicated, assume that no section 987 elections are in effect. Depreciation is ignored for purposes of this example.

(1) *Facts*—(i) *In general*. U.S. Corp, a domestic corporation with the dollar as its functional currency, operates in the United Kingdom through Business A, a section 987 QBU with the pound as its functional currency. The net unrecognized section 987 gain for Business A as determined under §1.987-4 as of the last day of year 2 is $80.

(ii) *Year 1 balance sheet*. At the end of year 1, the following assets are attributable to Business A: cash of £3,350; a computer with an adjusted basis of £500; and a machine with an adjusted basis of £500. Thus, the aggregate basis of Business A's assets is £4,350. Business A has no liabilities.

(iii) *Transfers and income in year 2*. During year 2, Business A earned income of £1,500. In addition, the following transfers took place between U.S. Corp and Business A in year 2. On January 5, year 2, U.S. Corp transferred to Business A £300 (acquired by U.S. Corp immediately before the transfer). On March 5, year 2, Business A transferred a machine (with an adjusted basis of £500) to U.S. Corp. On November 1, year 2, Business A transferred £2,300 to U.S. Corp. On December 7, year 2, U.S. Corp transferred a truck to Business A. The adjusted basis of the truck, when properly translated into pounds under §1.987-2(d), is £2,000.

(iv) *Year 2 balance sheet*. At the end of year 2, the following assets are attributable to Business A: cash of £2,850, a computer with a pound adjusted basis of £500, and a truck with a pound adjusted basis of £2,000. Thus, the aggregate basis of Business A's assets is £5,350. Business A has no liabilities.

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

(i) *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 QBU's functional currency (pounds) on the last day of year 2. The amount of the remittance for year 2 is £500, determined as follows:

Table 1 to paragraph (g)(2)(i)

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

(ii) *Alternative computation of remittance amount*. Under paragraph (c)(2) of this section, U.S. Corp can compute the amount of the remittance for year 2 using the following steps.

(A) *Step 1: Change in QBU net value*. The change in Business A's QBU net value is equal to £1,000 (£5,350 - £4,350).

(B) *Step 2: Adjustment for income or loss*. The amount determined in step 1 (£1,000) is reduced by Business A's income for year 2 of £1,500, to negative £500.

(C) *Step 3: Multiply by negative one*. The amount determined in step 2 (negative £500) is multiplied by negative one. The remittance for year 2 is equal to £500.

(iii) *Computation of section 987 QBU gross assets plus remittance*. Under paragraph (b)(1)(ii) of this section, Business A must determine the aggregate basis of its gross assets and must increase this amount by the amount of the remittance.

Table 2 to paragraph (g)(2)(iii)

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

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

(v) *Computation of section 987 gain or loss*. The amount of U.S. Corp's section 987 gain or loss that is recognized with respect to Business A is determined under paragraph (a) of this section by multiplying the 0.085 remittance proportion by the $80 of net unrecognized section 987 gain. U.S. Corp's resulting recognized section 987 gain for year 2 is $6.80.

(3) *Annual recognition election*. If an annual recognition election under paragraph (b)(2) of this section were in effect for year 2, U.S. Corp's remittance proportion would be one. Accordingly, U.S. Corp would recognize all $80 of the net unrecognized section 987 gain with respect to Business A.

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

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

(b) *Character and source of section 987 gain or loss.* With respect to each section 987 QBU, the character and source of section 987 gain or loss is determined under this paragraph (b) for all purposes of the Internal Revenue Code, including sections 904(d), 907, and 954.

(1) *Timing of character and source determination*. The character and source of section 987 gain or loss is determined based on the initial assignment pursuant to paragraph (b)(2)(i) of this section and may be reassigned in the year in which the section 987 gain or loss is recognized pursuant to paragraph (b)(2)(ii) of this section. The initial assignment is made in the earliest of the taxable years described in paragraphs (b)(1)(i) through (iv) of this section.

(i) The taxable year in which net unrecognized section 987 gain or loss is recognized.

(ii) The taxable year in which net unrecognized section 987 loss or pretransition loss becomes suspended section 987 loss.

(iii) The taxable year in which net unrecognized section 987 gain or loss becomes deferred section 987 gain or loss.

(iv) In the case of pretransition gain or loss that is recognized ratably over the transition period pursuant to the election under §1.987-10(e)(5)(ii), the taxable year that includes the transition date.

(2) *Method for determining the character and source of section 987 gain or loss*—(i) *Initial assignment*—(A) *In general*. In the taxable year of the initial assignment, determined under paragraph (b)(1) of this section, the owner assigns gross section 987 gain or loss to the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the assets of the section 987 QBU are assigned to the groupings under the asset method in §§1.861-9(g) and 1.861-9T(g), as modified by this paragraph (b)(2)(i). For purposes of applying the asset method, the owner takes into account only the assets that are attributable to the section 987 QBU under §1.987-2(b). *See* §1.987-11(e) and (f) (grouping of section 987 gain and loss and applying the loss-to-the-extent-of-gain rule on basis of the initial assignment of section 987 gain and loss under this paragraph (b)(2)(i)).

(B) *Special rules for applying the asset method to assign section 987 gain or loss*. For purposes of assigning gross section 987 gain or loss to the statutory and residual groupings under paragraph (b)(2)(i)(A) of this section, the proportions in which the tax book value of the assets of the section 987 QBU are assigned to the groupings described in paragraph (b)(2)(i)(A) of this section are determined without regard to section 987 gain or loss. Further, the section 987 gain or loss is assigned after any reattribution of gross income required under §1.904-4(f)(2)(vi) or §1.951A-2(c)(7)(ii)(B)(*2*) (or the principles thereof, as applicable), but before the allocation and apportionment of expenses or the application of provisions that are based on a net income computation, such as the high-tax exception to passive category income in §1.904-4(c), the high-tax exception to foreign base company income in §1.954-1(d), and the high-tax exclusion from tested income in §1.951A-2(c)(7).

(C) *Election to treat section 987 gain or loss that is assigned to subpart F income groups relating to foreign personal holding company income as attributable to section 988 transactions*—(*1*) *In general*. If an election is made under this paragraph (b)(2)(i)(C)(*1*), section 987 gain or loss assigned under paragraphs (b)(2)(i)(A) and (B) of this section to any grouping of passive foreign personal holding company income, as described in §1.960-1(d)(2)(ii)(B)(2)(i), is treated as foreign currency gain of the owner attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation, or as loss allocated and apportioned to such foreign currency gain. *See* §1.987-1(g) for rules that apply to section 987 elections.

(*2*) *Coordination with §1.954-2(g)*. The rules of §1.954-2(g)(2), (3) and (4) apply without regard to any section 987 gain treated as gain from section 988 transactions, or loss allocated and apportioned to such gain, by reason of an election under paragraph (b)(2)(i)(C)(*1*) of this section.

(D) *Section 987 gain or loss assigned to tentative tested income rather than tested income*—(*1*) *In general.* In the case of a controlled foreign corporation, section 987 gain or loss is initially assigned to tentative tested income within a section 904 category (a *tentative tested income group*) under paragraphs (b)(2)(i)(A) and (B) of this section as though the election described in §1.951A-2(c)(7)(viii) is in effect for the taxable year. As a result, section 987 gain or loss that would have initially been characterized as tested income if no election under §1.951A-2(c)(7)(viii) was in effect is initially characterized as tentative tested income.

(*2*) *For purposes of the GILTI high-tax exclusion, section 987 gain or loss is not attributable to any tested unit*. In the case of a controlled foreign corporation, the initial assignment of section 987 gain or loss is made as though the section 987 gain or loss was not attributable to any tested unit for purposes of applying §1.951A-2(c)(7) (GILTI high-tax exclusion). *See* paragraph (b)(2)(iii) of this section (applying the GILTI high-tax exclusion by treating all section 987 gain or loss in the same tentative tested income group as composing a single tentative tested income item).

(ii) *Reassignment of section 987 gain or loss*. In the taxable year in which section 987 gain or loss is recognized (determined by taking into account §§1.987-5, 1.987-11(e), 1.987-12(c), and 1.987-13(b) through (d), if applicable), the section 987 gain or loss is sourced and characterized based on the initial assignment in paragraph (b)(2)(i) of this section, but with appropriate changes to account for the application of provisions that apply to the section 987 gain or loss based on a net income computation such as the high-tax exception to passive category income in §1.904-4(c), the high-tax exception to foreign base company income in §1.954-1(d), and the high-tax exclusion to tested income in §1.951A-2(c)(7). Thus, for example, if an election under §1.951A-2(c)(7)(viii) is in effect for the taxable year, section 987 gain or loss initially assigned to a tentative tested income group will be reassigned to a tested income group (as defined in §1.960-1(d)(2)(ii)(C)) or to the residual income group (as defined in §1.960-1(d)(2)(ii)(D)), as applicable, depending on whether the item of income (as described in paragraph (b)(2)(iii) of this section) is subject to a high rate of tax (as determined under §1.951A-2(c)(7)(vi)). If no election is made under §1.951A-2(c)(7)(viii) for a taxable year, all of the section 987 gain or loss that is recognized in the taxable year that was initially assigned to tentative tested income under paragraph (b)(2)(i) of this section, is reassigned to the appropriate tested income group (as defined in §1.960–1(d)(2)(ii)(C)).

(iii) *Special rule for the application of the GILTI high-tax exclusion to section 987 gain or loss*. Section 987 gain in a tentative tested income group that is recognized by a controlled foreign corporation in a taxable year comprises a single tentative gross tested income item (as if it were allocable to its own tested unit) within the meaning of §1.951A-2(c)(7)(ii), and section 987 loss in a tentative tested income group that is recognized by a controlled foreign corporation in the taxable year is allocated and apportioned to the corresponding tentative gross tested income item for purposes of calculating the tentative tested income item within the meaning of §1.951A-2(c)(7)(iii). Thus, for purposes of applying the high-tax exclusion in §1.951A-2(c)(7), all of the section 987 gain and loss in a tentative tested income group that is recognized by the controlled foreign corporation in a taxable year is a single tentative tested income item.

(3) *Allocation and apportionment of foreign income tax to section 987 items under section 861*. For purposes of applying the definition of a corresponding U.S. item in §1.861-20(b), an item of foreign gross income and an item of section 987 gain or loss are treated as arising from the same transaction or other realization event only if the requirements in both paragraphs (b)(3)(i) and (ii) of this section are satisfied.

(i) *The foreign gross income is an item of foreign currency gain or loss*. The owner of the section 987 QBU, original deferral QBU owner, or original suspended loss QBU owner includes the foreign gross income under the laws of the foreign country in which it is a tax resident because under that foreign law it is required to recognize foreign currency gain or loss with respect to its interest in the section 987 QBU or with respect to a successor deferral QBU or successor suspended loss QBU.

(ii) *The same event or events give rise to both the foreign gross income and the section 987 gain or loss*. The remittance under §1.987-5(c) that gave rise to the item of section 987 gain or loss comprises one or more of the events that gave rise to the item of foreign gross income described in paragraph (b)(3)(i) of this section.

(c) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, except as otherwise indicated, assume that no section 987 elections are in effect.

(1) *Example 1: Initial assignment and reassignment of section 987 gain or loss*—(i) *Facts*. CFC is a controlled foreign corporation with the Swiss franc (*Sf*) as its functional currency. CFC is the owner of Business A, a section 987 QBU that has the euro as its functional currency. For year 1, CFC does not have an election described in §1.951A-2(c)(7)(viii) in effect but is subject to an election under paragraph (b)(2)(i)(C) of this section. CFC recognizes section 987 gain of Sf10,000 under §1.987-5. Business A has average total assets of Sf1,000,000 in year 1, which generate income (other than section 987 gain) as follows: Sf750,000 of assets that produce gross income in the statutory grouping for foreign source general category tested income under sections 904(d)(1)(A) and 951A; and Sf250,000 of assets that produce foreign source passive gross income in one of the groupings described in §§1.960-1(d)(2)(ii)(B)(*2*)(*i*) and 1.954-1(c)(1)(iii)(B) (subpart F income groups relating to passive foreign personal holding company income).

(ii) *Analysis*. Under paragraphs (b)(2)(i)(A), (B), and (D) of this section, Sf7,500 (Sf750,000/Sf1,000,000 x Sf10,000) of the section 987 gain is initially assigned to the statutory grouping of foreign source general category tentative tested income. Because an election under §1.951A-2(c)(7)(viii) is not in effect for the taxable year in which the section 987 gain is recognized, the section 987 gain is reassigned under paragraph (b)(2)(ii) of this section to foreign source general category tested income. The remaining Sf2,500 (Sf250,000/Sf1,000,000 x Sf10,000) is characterized under paragraphs (b)(2)(i)(A) and (B) of this section by reference to assets that give rise to foreign source passive gross income in one of the groupings described in §1.960-1(d)(2)(ii)(B)(*2*)(*i*) (subpart F income groups relating to passive foreign personal holding company income) and is therefore generally treated under the election in paragraph (b)(2)(i)(C) of this section as foreign source foreign currency gain of CFC attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation. All of the section 987 gain is treated as ordinary income under paragraph (a) of this section.

(2) *Example 2*: *Effect of GILTI high-tax exclusion—(i) Facts.* The facts are the same as in paragraph (c)(1) of this section (*Example 1*) except that CFC does have an election described in §1.951A-2(c)(7)(viii) in effect. Without regard to the section 987 gain or loss, CFC has two tentative gross tested income items: Sf100,000 of gross tentative tested income attributable to a CFC tested unit (the CFC item) and Sf5,000,000 of gross tentative tested income attributable to a Business A tested unit (the Business A item). CFC accrues Sf1,010,000 of current year taxes and has no other current year deductions. CFC is not required by its country of tax residence to include in foreign gross income foreign currency gain or loss with respect to its interest in a foreign QBU. For purposes of § 1.951A-2(c)(7)(iii)(A), Sf1,000,000 of current year tax is allocated and apportioned to the Business A item and Sf10,000 is allocated and apportioned to the CFC item. At all relevant times Sf1 = $1.

(ii) *Analysis*. As in paragraph (c)(1)(ii) of this section (*Example 1*), Sf7,500 of section 987 gain is initially assigned to the statutory grouping of foreign source general category tentative tested income. Under paragraph (b)(2)(iii) of this section, the section 987 gain comprises a single tentative gross tested income item of the CFC (the section 987 item). Therefore, the CFC has three tentative gross tested income items: the section 987 item, the CFC item, and the Business A item. No tax is allocated and apportioned to the section 987 item. *See* paragraph (b)(3) of this section. Applying §1.951A-2(c)(7)(vi), the effective tax rate of the section 987 item is 0% ($0/$7,500), the effective tax rate of the CFC item is 10% ($10,000/$100,000), and the effective tax rate of the Business A item is 20% ($1,000,000/$5,000,000). An election under §1.951A-2(c)(7)(viii) is in effect; therefore, the section 987 gain is reassigned based on the application of §1.951A-2(c)(7). Because the section 987 item was not subject to an effective tax rate of greater than 90 percent of the maximum rate of tax specified in section 11, it is reassigned under paragraph (b)(2) of this section to foreign source general category tested income. The remaining Sf2,500 of section 987 gain is foreign source foreign currency gain of CFC attributable to section 988 transactions not directly related to the business needs of the controlled foreign corporation for the reasons stated in paragraph (c)(1)(ii) of this section (*Example 1*).

(3) *Example 3: Section 987 gain or loss treated as attributable to section 988 transactions*—(i) *Facts*. The facts are the same as in paragraph (c)(1) of this section (*Example 1*) except that CFC recog-

nizes section 987 loss of Sf40,000, Sf5,000 of which is characterized under paragraphs (b)(2)(i)(A) and (B) of this section by reference to assets that give rise to foreign source passive gross income in a separate subpart F income group for non-related party interest income of Business A and Sf5,000 of which is characterized by reference to assets that give rise to foreign source passive gross income in a separate subpart F income group for gains from certain property transactions of Business A not derived from the active conduct of a trade or business. CFC otherwise has Sf12,000 of net foreign currency gain determined under §1.954-2(g) that is taken into account in determining the excess of foreign currency gain over foreign currency losses characterized as foreign personal holding company income under section 954(c)(1)(D).

(ii) *Analysis*. Under paragraph (b)(2)(i)(C) of this section, the Sf10,000 total section 987 loss characterized by reference to assets that give rise to foreign source passive gross income in one of the groupings described in §§1.960-1(d)(2)(ii)(B)(*2*)(*i*) and 1.954-1(c)(1)(iii)(B) (subpart F income groups relating to passive foreign personal holding company income) is treated as foreign source foreign currency loss of CFC attributable to section 988 transactions. Accordingly, CFC will aggregate the Sf10,000 section 987 loss with the Sf12,000 net foreign currency gain and will have Sf2,000 of net foreign currency gain characterized as passive foreign personal holding company income under section 954(c)(1)(D).

(4) *Example 4*: *Section 987 gain or loss assigned to passive foreign personal holding company income*—(i) *Facts*. The facts are the same as in paragraph (c)(3) of this section (*Example 3*) except that CFC is not subject to an election under paragraph (b)(2)(i)(C) of this section.

(ii) *Analysis*. As the CFC is not subject to an election under paragraph (b)(2)(i)(C) of this section, Sf5,000 of section 987 loss is initially assigned to the statutory grouping for foreign source passive gross income in a separate subpart F income group for non-related party interest income of Business A, and Sf5,000 is initially assigned to the statutory grouping for foreign source passive gross income in a separate subpart F income group for gains from certain property transactions of Business A not derived from the active conduct of a trade or business. The Sf12,000 net foreign currency gain is foreign source passive gross income in a separate subpart F income group for foreign currency gain of CFC attributable to section 988 transactions of CFC. As a result, if the net income in a subpart F income group to which either section 987 loss is assigned is less than zero, that loss will not reduce any other category of subpart F income, including CFC's foreign currency gain from section 988 transactions, except by reason of the earnings and profit limitation in section 952(c)(1). *See* §1.954-1(c)(1)(ii).

§1.987-7 Application of the section 987 regulations to partnerships and S corporations.

(a) *Overview*. This section provides rules relating to the application of the section 987 regulations to partnerships and S corporations. Paragraph (b) of this section provides the general rule that the section 987 regulations do not apply to partnerships. Paragraph (c) of this section identifies certain provisions of the section 987 regulations that are applicable to partnerships, subject to certain modifications. Paragraph (d) of this section provides special rules relating to suspended section 987 loss. Paragraph (e) of this section provides rules for adjusting a partner's basis in its partnership interest. Paragraph (f) of this section provides that S corporations are treated in the same manner as partnerships for purposes of the section 987 regulations. Paragraph (g) of this section provides examples that illustrate the rules of this section.

(b) *Section 987 regulations generally do not apply to partnerships*. Except as otherwise provided in this section, the section 987 regulations do not apply to a partnership, and the section 987 regulations do not apply to an eligible QBU if a partnership is the owner for Federal income tax purposes of the eligible QBU's assets and liabilities. However, a taxpayer must apply sections 987 and 989(a) to partnerships and eligible QBUs of partnerships in a reasonable manner using a method that is applied consistently from year to year with respect to a particular partnership or eligible QBU. In addition, all members of the same controlled group must apply the same method consistently with respect to a particular partnership or eligible QBU.

(c) *Provisions of the section 987 regulations that apply to partnerships*—(1) *In general*—(i) *Eligible QBU*. The rules described in paragraph (c)(2) of this section apply to an eligible QBU if a partnership is the owner for Federal income tax purposes of the eligible QBU's assets and liabilities and either—

(A) The partnership (or a partner) treats the eligible QBU as a qualified business unit of the partnership that is subject to section 987 (for example, under an entity approach); or

(B) A partner in the partnership treats all or a portion of the eligible QBU as a qualified business unit of the partner that is subject to section 987 (for example, under an aggregate approach).

(ii) *Partnership*. The rules described in paragraph (c)(2) of this section apply to a partnership if a partner in the partnership treats the partnership itself (or an interest in the partnership) as a qualified business unit that is subject to section 987 (for example, under an entity approach).

(2) *Applicable provisions*—(i) *In general*. Sections 1.987-6 (character and source of section 987 gain or loss), 1.987-9(d) (information on a dedicated section 987 form), §§1.987-11 through 1.987-13 (suspended section 987 loss, deferral of section 987 gain or loss, and suspended section 987 loss upon terminations, respectively), and §1.987-15 (applicability dates) apply to a QBU described in paragraph (c)(1) of this section, subject to the modifications described in this paragraph (c) and in paragraph (d) of this section.

(ii) *Annual recognition election*. An annual recognition election under §1.987-5(b)(2) applies to a QBU described in paragraph (c)(1) of this section, subject to the modifications described in this paragraph (c). In each taxable year of the owner of a QBU described in paragraph (c)(1) of this section in which an annual recognition election is in effect, the owner recognizes any unrecognized gain or loss with respect to the QBU under section 987(3) (other than suspended section 987 loss) as though the QBU terminated on the last day of the taxable year. Appropriate adjustments must be made to prevent the gain or loss from being taken into account again after it is recognized under this paragraph (c)(2)(ii) (for example, in the case of a taxpayer applying the 1991 proposed regulations, by adjusting the equity and basis pools to reflect the gain or loss recognized). The rules of §1.987-1(g) apply with respect to an annual recognition election that is made by or for an owner of a QBU described in paragraph (c)(1) of this section.

(iii) *Section 988 mark-to-market election*. A section 988 mark-to-market election under §1.987-3(b)(4)(ii) applies to a QBU described in paragraph (c)(1) of this section. The rules of §1.987-1(g) apply with respect to a section 988 mark-to-market election that is made by or for an owner of a QBU described in paragraph (c)(1) of this section.

(3) *Modifications to applicable provisions*—(i) *In general*. An owner of a QBU described in paragraph (c)(1) of this section must adapt the rules

described in paragraph (c)(2) of this section as necessary to recognize section 987 gain or loss in a manner that is consistent with the principles of those rules. For purposes of applying this section and the rules described in paragraph (c)(2) of this section to a QBU described in paragraph (c)(1) of this section, the definitions provided in the section 987 regulations apply with appropriate modifications. For example, in the case of a QBU described in paragraph (c)(1) of this section, the term section 987 gain or loss means gain or loss recognized under section 987(3), the term owner means the person that recognizes gain or loss under section 987(3), and the term section 987 QBU means any qualified business unit subject to section 987 (including a QBU described in paragraph (c)(1) of this section). In addition, references to other rules of the section 987 regulations must be adapted as necessary to apply section 987 in a manner that is consistent with the principles of this section and the rules described in paragraphs (c)(2) of this section. For example, references to the recognition of section 987 gain or loss under §1.987-5 encompass any recognition of gain or loss under section 987(3).

(ii) *Controlled group*. For purposes of applying §§1.987-12 and 1.987-13, if a partner in a partnership is treated as the owner of an eligible QBU described in paragraph (c)(1)(i) of this section (for example, under an aggregate approach) before the QBU terminates, each member of the partnership's controlled group is treated as a member of the partner's controlled group at any time that the partner (or any member of the partner's controlled group, determined without regard to this paragraph (c)(3)(ii)) continues to be a direct or indirect partner in the partnership. This paragraph (c)(3)(ii) does not apply for purposes of the de minimis rule in §1.987-11(c)(2).

(4) *Terminating QBUs*. In the case of a terminating QBU described in paragraph (c)(1) of this section, the rules of this section and the rules described in paragraph (c)(2) of this section apply immediately before the termination, but §1.987-10 does not apply because §1.987-10 is not applicable to a QBU described in paragraph (c)(1) of this section.

(d) *Suspended section 987 loss*—(1) *In general*—(i) *Rules of §1.987-11(c) and (d)(2) do not apply*. The rules of §1.987-11(c) and (d)(2) do not apply to a QBU described in paragraph (c)(1) of this section.

(ii) *Suspension of section 987 loss*. Except as provided in paragraph (d)(2) of this section, any loss that would otherwise be recognized under section 987(3) (after applying §1.987-12) with respect to a QBU described in paragraph (d)(1)(ii)(A) or (B) of this section is not recognized and becomes suspended section 987 loss.

(A) *Eligible QBU*. This paragraph (d)(1)(ii) applies to an eligible QBU described in paragraph (c)(1)(i) of this section.

(B) *Partnership*. This paragraph (d)(1)(ii) applies to a partnership (or a partnership interest) described in paragraph (c)(1)(ii) of this section if at least 95 percent of the interests in partnership capital and profits are owned, directly or indirectly, by persons related to each other within the meaning of section 267(b) or section 707(b). For this purpose, ownership of an interest in partnership capital or profits is determined in accordance with the rules for constructive ownership provided in section 267(c), other than section 267(c)(3).

(2) *Exceptions*—(i) *Method under which historic items do not give rise to section 987 gain or loss*. Paragraph (d)(1)(ii) of this section does not apply to an eligible QBU described in paragraph (d)(1)(ii)(A) of this section if section 987 is consistently applied to the QBU using a method under which historic items of the QBU do not give rise to section 987 gain or loss (for example, a method that follows the principles of §§1.987-3 through 1.987-5).

(ii) *Annual recognition election*. Paragraph (d)(1)(ii) of this section does not apply in a taxable year in which an annual recognition election is in effect.

(iii) *De minimis rule*. Paragraph (d)(1)(ii) of this section does not apply in a taxable year described in §1.987-11(c)(2).

(3) *Recognition of suspended section 987 loss*—(i) *In general*. Except as provided in paragraph (d)(3)(ii) of this section, suspended section 987 loss with respect to a QBU described in paragraph (d)(1)(ii)(A) or (B) of this section is recognized under the rules of §§1.987-11(e) and 1.987-13.

(ii) *Partnership that is not engaged in a trade or business.* In the case of a partnership described in paragraph (d)(1)(ii)(B) of this section that is not engaged in a trade or business, suspended section 987 loss cannot be recognized under §1.987-13(b) through (d) (and thus can only be recognized under §1.987-11(e)).

(iii) *Application of the loss-to-the-extent-of-gain rule*. If a partner in a partnership is the owner of a section 987 QBU described in paragraph (c)(1) of this section and also owns one or more section 987 QBUs that are not described in paragraph (c)(1) of this section, the loss-to-the-extent-of-gain rule of §1.987-11(e) is applied by taking into account all of the owner's section 987 gain and suspended section 987 loss in each recognition grouping with respect to all of its section 987 QBUs (whether or not they are described in paragraph (c)(1) of this section).

(e) *Adjustments to the basis of a partner's interest in the partnership*. When, and to the extent that, a partner recognizes section 987 gain or loss, defers section 987 gain or loss, or suspends section 987 loss at the partner level with respect to a partnership described in paragraph (c)(1)(ii) of this section or an eligible QBU of the partnership described in paragraph (c)(1)(i) of this section, the principles of sections 704(d) and 705 apply as though the item of income or loss was part of the partner's distributive share of partnership items. Thus, proper adjustments must be made to the partner's adjusted basis in the partnership under the principles of section 705, taking into account the principles of section 704(d).

(f) *S corporations treated as partnerships*. For purposes of the section 987 regulations, S corporations are treated in the same manner as partnerships and shareholders of S corporations are treated in the same manner as partners of partnerships.

(g) *Examples*. The following examples illustrate the principles of this section. For purposes of these examples, DC1 and DC2 are domestic corporations, and P is a foreign partnership. P is also the owner for Federal income tax purposes of the assets and liabilities of Business A, an eligible QBU that has the pound as its functional currency. DC1 and DC2 each own 50% of the capital and profits interests in P. If P is treated as a qualified business unit under section 989(a), P would have the euro as its functional currency due to activities unrelated to Business A.

(1) *Example 1: Aggregate approach to section 987*—(i) *Facts*. DC1 and DC2 each apply section 987 using an aggregate approach, under which each partner's indirect interest in Business A is treated as a section 987 QBU of the partner. DC1 and DC2 each use the earnings and capital method described in the 1991 proposed regulations to apply section 987 with respect to Business A. Neither DC1 nor DC2 has made an annual recognition election. Under the earnings and capital method, but for the application of paragraph (d)(1)(ii) of this section, DC1 and DC2 each would recognize section 987 loss of $10 million in year 1 with respect to Business A.

(ii) *Analysis*—(A) *Application of loss suspension rule to Business A*. Business A is an eligible QBU described in paragraph (c)(1)(i) of this section because a partnership (P) is the owner of Business A's assets and liabilities for federal income tax purposes and P's partners treat Business A as a section 987 QBU. Therefore, under paragraph (d)(1)(ii) of this section, the section 987 loss of DC1 and DC2 that would otherwise be recognized in year 1 becomes suspended section 987 loss, which DC1 and DC2 may recognize in year 1 or in future taxable years under §§1.987-11(e) and 1.987-13(b) through (d).

(B) *Annual recognition election*. If DC1 and DC2 were subject to an annual recognition election in year 1, they would recognize section 987 gain or loss with respect to Business A as though Business A terminated at the end of year 1, and the loss suspension rule of paragraph (d)(1)(ii) of this section would not apply.

(C) *FEEP method*. If DC1 and DC2 applied section 987 to Business A under the principles of §§1.987-3 through 1.987-5, such that historic items of Business A did not give rise to section 987 gain or loss, the loss suspension rule of paragraph (d)(1)(ii) of this section would not apply.

(2) *Example 2: Entity approach to section 987*—(i) *Facts*. P applies section 987 to Business A using an entity approach, under which Business A is treated as a section 987 QBU of P. P is treated as a qualified business unit under section 989(a) and uses the euro as its functional currency. P uses the earnings and capital method described in the 1991 proposed regulations to apply section 987 with respect to Business A. Under the earnings and capital method, but for the application of paragraph (d)(1)(ii) of this section, P would recognize section 987 loss of $10 million in year 1 with respect to Business A. In addition, DC1 and DC2 apply section 987 to P using an entity approach, treating each partner's interest in P as a section 987 QBU. DC1 and DC2 each use the earnings and capital method described in the 1991 proposed regulations to apply section 987 with respect to P. Under the earnings and capital method, but for the application of paragraph (d)(1)(ii) of this section, DC1 and DC2 each would recognize section 987 loss of $10 million in year 1 with respect to P. Neither DC1 nor DC2 has made an annual recognition election.

(ii) *Analysis*—(A) *Business A treated as a QBU subject to section 987*. Business A is an eligible QBU described in paragraph (c)(1)(i) of this section because a partnership (P) is the owner of Business A's assets and liabilities for Federal income tax purposes, and P treats Business A as a QBU subject to section 987. Therefore, the loss suspension rule in paragraph (d)(1)(ii) of this section applies to suspend P's recognition of section 987 loss with respect to Business A.

(B*) Treatment of P as a section 987 QBU*. P is a partnership described in paragraph (c)(1)(ii) of this section because DC1 and DC2 each treat their interest in P as a section 987 QBU. Under paragraph (d)(1)(ii)(B) of this section, if DC1 and DC2 are related within the meaning of section 267(b) or section 707(b), the loss suspension rule in paragraph (d)(1)(ii) of this section applies to suspend DC1's and DC2's recognition of section 987 loss with respect to their interest in P. However, if DC1 and DC2 are unrelated, the loss suspension rule in paragraph (d)(1)(ii) of this section does not apply.

§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 is reserved. Paragraph (e) of this section describes certain effects of terminations. Paragraph (f) of this section contains examples that illustrate the principles of this section.

(b) *In general*. Except as provided in paragraph (c) of this section, a section 987 QBU terminates if the conditions described in any one of paragraphs (b)(1) through (6) of this section are satisfied.

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

(2) *Substantially all assets transferred*. The section 987 QBU transfers substantially all (within the meaning of section 368(a)(1)(C)) of its assets to its owner. For purposes of this paragraph (b)(2), the amount of assets transferred from the section 987 QBU to its owner as a result of a transaction is reduced by the amount of assets transferred from the owner to the section 987 QBU pursuant to the same transaction. *See* paragraphs (f)(2), (6), and (7) of this section (*Examples 2*, *6*, and *7*).

(3) *Owner no longer a CFC*. A foreign corporation that is a controlled foreign corporation that is the owner of a section 987 QBU ceases to be a controlled foreign corporation as a result of a transaction or series of transactions after which persons that were related to the corporation within the meaning of section 267(b) immediately before the transaction or series of transactions collectively own sufficient interests in the corporation such that the corporation would continue to be considered a controlled foreign corporation if such persons were United States shareholders within the meaning of section 951(b). *See* paragraph (f)(3) of this section (*Example 3*).

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

(5) *Section 987 QBU ceases to be an eligible QBU with a functional currency different from its owner*. The section 987 QBU ceases to be an eligible QBU that has a functional currency different from its owner. *See* §1.985-5(d)(2) and (e)(4)(iii) (providing that a termination resulting from a change in functional currency occurs on the last day of the last taxable year ending before the year of change).

(6) *Change in form of ownership*. An individual or corporation that was the direct owner of a section 987 QBU ceases to be the direct owner of the section 987 QBU (for example, because the assets of the section 987 QBU are transferred to a partnership).

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

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

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

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

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

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

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

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

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

(d) [Reserved]

(e) *Effect of terminations*. A termination of a section 987 QBU as determined in this section is treated as a remittance of all the gross assets of the section 987 QBU to its owner immediately before the section 987 QBU terminates. Thus, except as otherwise provided in the section 987 regulations, a termination generally results in the recognition of any net unrecognized section 987 gain or loss of the section 987 QBU (unless it is treated as deferred section 987 gain or loss or suspended section 987 loss). *See* §1.987-5(c)(3) (generally recognizing section 987 gain or loss on a termination) and §§1.987-11 through 1.987-13 (suspending section 987 gain or loss and deferring section 987 loss in certain instances).

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

(1) *Example 1: Cessation of operations*—(i) *Facts*. U.S. Corp is the owner of Business A, a sales office of U.S. Corp in Country X. Business A ceases sales activities on December 31, year 1. During year 2, Business A sells all of the assets used in its sales activities and winds up its business, settling outstanding accounts.

(ii) *Analysis*. Business A's trade or business ceases on December 31, year 1. The cessation of Business A's trade or business causes a termination of the Business A section 987 QBU under paragraph (b)(1) of this section on December 31, year 1, unless U.S. Corp chooses to continue to treat Business A as a section 987 QBU until completion of the wind-up activities in year 2. If U.S. Corp chooses to continue to treat Business A as a section 987 QBU during the wind-up of Business A, the Business A section 987 QBU would terminate under paragraph (b)(1) of this section upon completion of the wind-up in year 2.

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

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

(3) *Example 3: Cessation of controlled foreign corporation status*—(i) *Facts*. Foreign parent (FP) is a foreign corporation that owns all the stock of U.S. Corp, a domestic corporation. U.S. Corp owns all of the stock of FC, a controlled foreign corporation as defined in section 957. FC is the owner of Business A. U.S. Corp liquidates into FP. FC no longer constitutes a controlled foreign corporation after the liquidation.

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

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

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

(5) [Reserved]

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

(ii) *Analysis*—(A) Under §1.987-1(b)(5), U.S. Corp is the owner of Business A and Business B. In year 6, when Entity A elects to be classified as a corporation, U.S. Corp is deemed to contribute the assets and liabilities of Business A and Business B to FC under section 351 in exchange for FC stock. Pursuant to §1.987-2(c)(2)(i) and (ii), as a result of the deemed exchange of the assets and liabilities of Business A and Business B for FC stock in a section 351 transaction, Business A and Business B are each treated as transferring their assets and liabilities to U.S. Corp immediately before U.S. Corp's transfer of such assets and liabilities to FC. The transfer of assets from Business A and Business B to U.S. Corp causes terminations of those section 987 QBUs under paragraph (b)(2) of this section. The assets and liabilities of Business A and Business B are now owned by FC, but because FC and Business A have the same functional currency, only Business B qualifies as a section 987 QBU to which section 987 applies.

(B) Terminations also would have occurred in year 6 if U.S. Corp had contributed Entity A and Entity B to an existing foreign corporation owned by U.S. Corp or to a newly created foreign corporation owned by U.S. Corp pursuant to a section 351 exchange because the transfer of all of the assets of Business A and Business B would cause terminations of those section 987 QBUs under paragraph (b)(2) of this section.

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

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

§1.987-9 Recordkeeping requirements.

(a) *In general*. An owner (or the authorized person on behalf of an owner) must keep a copy of the statement described in §1.987-1(g)(3)(i) for each section 987 election made by or on behalf of the owner (if not required to be made on a form published by the Commissioner) and reasonable records sufficient to establish section 987 taxable income or loss and section 987 gain or loss with respect to each section 987 QBU, successor deferral QBU, and successor suspended loss QBU, as applicable, for each taxable year.

(b) *Supplemental information*. A person's obligation to maintain records under section 6001 and paragraph (a) of this section is not satisfied unless the following information is maintained in those records with respect to each section 987 QBU, successor deferral QBU, and successor suspended loss QBU for each taxable year:

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

(2) The adjusted balance sheet of the section 987 QBU in the functional currency of the section 987 QBU and its owner. If a current rate election is in effect and the owner computes QBU net value under §1.987-4(e)(2)(iii) without preparing an adjusted balance sheet, the information needed to apply §1.987-4(e)(2)(iii) must be maintained in lieu of an adjusted balance sheet.

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

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

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

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

(7) The amount of the unrecognized section 987 gain or loss for the taxable year determined under §1.987-4(d).

(8) The amount of the net accumulated unrecognized section 987 gain or loss for the taxable year determined under §1.987-4(c).

(9) The amount of the remittance and the remittance proportion for the taxable year.

(10) The computations required under §§1.861-9(g) and 1.861-9T(g) for purposes of sourcing and characterizing section 987 gain or loss, deferred section 987 gain or loss, suspended section 987 loss, or pretransition gain or loss under §1.987-6.

(11) The cumulative suspended section 987 loss in each recognition grouping.

(12) The outstanding deferred section 987 gain or loss in each recognition grouping.

(13) The transition information required to be determined under §1.987-10(k).

(14) The identification required under §1.987-14(c) with respect to a section 987 hedging transaction.

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

(d) *Information on a dedicated section 987 form*. Information necessary to determine section 987 gain or loss and section 987 taxable income or loss must be reported on a form prescribed for that purpose (or, until that form is published, on Form 8858 or its successor) in accordance with the applicable forms and instructions. A taxpayer satisfies its obligation described in paragraphs (a) and (b) of this section to the extent that the taxpayer provides the specific information required on Form 8858 (or its successor) or other form prescribed for this purpose (including the information required by the instructions accompanying those forms).

§1.987-10 Transition rules.

(a) *Overview*—(1) *In general*. This section provides transition rules for the first taxable year in which the section 987 regulations apply. Paragraph (b) of this section describes the scope of this section's application. Paragraph (c) of this section provides rules for determining the transition date. Paragraph (d) of this section provides rules relating to the application of the section 987 regulations after the transition date. Paragraph (e) of this section provides rules relating to the determination and recognition of pretransition gain or loss. Paragraph (f) of this section provides special rules for section 987 QBUs to which the fresh start transition method was applied. Paragraph (g) of this section is reserved. Paragraph (h) of this section provides rules relating to the source and character of pretransition gain or loss. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides adjustments to avoid double counting or omissions. Paragraph (k) of this section provides reporting requirements that apply in the taxable year beginning on the transition date. Paragraph (l) of this section provides examples illustrating the rules of this section.

(2) *Terms defined under prior §1.987-12*. For purposes of this section, the terms *deferral QBU*, *deferral QBU owner*, *successor QBU*, *outbound loss QBU*, *outbound section 987 loss*, and *qualified successor* have the meaning provided in prior §1.987-12.

(b) *Scope*—(1) *Owner of a section 987 QBU*. Except as provided in paragraph (f) of this section, any person that is an owner of a section 987 QBU on the applicable transition date and any person that is the owner of a terminating QBU on the termination date must apply the rules of this section with respect to the section 987 QBU.

(2) *Deferral QBU owner and owner of outbound loss QBU*. Except as provided

in paragraph (f) of this section, a deferral QBU owner or the owner of an outbound loss QBU must apply the rules of this section with respect to the deferral QBU or outbound loss QBU if the deferral event or outbound loss event occurred before the applicable transition date. This paragraph (b)(2) does not apply to the owner of a terminating QBU.

(c) *Transition date*—(1) *In general*. Except as provided in paragraph (c)(2) of this section, the transition date for a section 987 QBU, deferral QBU, or outbound loss QBU is the first day of the first taxable year described in §1.987-15(a)(1), (b), or (c) to which this section applies.

(2) *Terminating QBU*—(i) *In general*. With respect to a terminating QBU, the transition date is the day after the termination date. Until the transition date described in paragraph (c)(1) of this section, the owner of the terminating QBU must apply the section 987 regulations with respect to the terminating QBU, and any section 987 gain or loss attributable thereto, without regard to any section 987 elections (other than the election described in §1.987-6(b)(2)(i)(C)).

(ii) *Ordering rule*. In the case of a terminating QBU, the transition rules of this section are applied immediately before the termination, and the consequences of the termination are determined under the section 987 regulations after applying this section.

(d) *Application of the section 987 regulations after the transition date—(1) Owner functional currency net value on the last day of the preceding taxable year*. Except as provided in paragraph (f) of this section, for purposes of applying §1.987-4 in the taxable year beginning on the transition date, the owner functional currency net value of a section 987 QBU on the last day of the preceding taxable year under §1.987-4(d)(1)(i)(B) is determined by translating the assets and liabilities that are attributable to the section 987 QBU on the day before the transition date into the owner's functional currency at the transition exchange rate described in paragraph (d)(3) of this section.

(2) *Determination of historic rate*. If a current rate election is not in effect for the taxable year beginning on the transition date, the historic rate for historic items that are attributable to a section 987 QBU on the day before the transition date (other than non-LIFO inventory subject to the simplified inventory method under §1.987-3(c)(2)(iv)(A)) is the transition exchange rate described in paragraph (d)(3) of this section.

(3) *Transition exchange rate*—(i) *In general*. Except as provided in paragraph (d)(3)(ii) of this section, the transition exchange rate is the spot rate applicable to the day before the transition date.

(ii) *Earnings only method*. If an earnings only method described in paragraph (e)(4)(ii) of this section was applied with respect to a section 987 QBU before the transition date, and a current rate election is not in effect in the taxable year beginning on the transition date, the transition exchange rate for each historic item (other than inventory subject to the simplified inventory method under §1.987-3(c)(2)(iv)(A)) is the pretransition translation rate described in paragraph (e)(2)(i)(C) of this section. This paragraph (d)(3)(ii) does not apply with respect to a terminating QBU.

(e) *Pretransition gain or loss*—(1) *In general*. Except as provided in paragraph (f) of this section, pretransition gain or loss is determined and recognized under this paragraph (e).

(2) *Amount of pretransition gain or loss for an owner that applied an eligible pretransition method*—(i) *Owner of a section 987 QBU*. If an owner of a section 987 QBU described in paragraph (b)(1) of this section applied an eligible pretransition method with respect to the section 987 QBU, the amount of pretransition gain or loss with respect to the section 987 QBU is equal to the sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. *See* paragraphs (l)(1) through (3) of this section (*Examples 1* through *3*) for an illustration of this rule.

(A) *Deemed termination amount*. The deemed termination amount is the amount of section 987 gain or loss that would have been recognized by the owner under the eligible pretransition method if the section 987 QBU terminated and transferred all of its assets and liabilities to the owner on the day before the transition date and §§1.987-12 and 1.987-13 and prior §1.987-12 did not apply.

(B) *Owner functional currency net value adjustment*. The owner functional currency net value adjustment may be either positive or negative and is equal to the amount described in paragraph (e)(2)(i)(B)(*1*) of this section reduced by the amount described in paragraph (e)(2)(i)(B)(*2*) of this section.

(*1*) The basis of the assets, reduced by the amount of liabilities, that are attributable to the section 987 QBU on the day before the transition date, translated into the owner's functional currency at the transition exchange rate.

(*2*) The basis of the assets, reduced by the amount of liabilities, that are attributable to the section 987 QBU on the day before the transition date, translated into the owner's functional currency at the pretransition translation rate.

(C) *Pretransition translation rate*. The pretransition translation rate is the rate that would be used under the eligible pretransition method to determine the basis of an asset or the amount of a liability in the hands of the owner of a section 987 QBU if the section 987 QBU transferred all of its assets and liabilities to the owner on the day before the transition date.

(ii) *Deferral QBU owner*. If a deferral QBU owner described in paragraph (b)(2) of this section applied an eligible pretransition method with respect to the deferral QBU, the amount of pretransition gain or loss with respect to the deferral QBU is equal to the deferred section 987 gain or loss (determined under prior §1.987-12) that was not recognized before the transition date with respect to the deferral QBU.

(iii) *Owner of an outbound loss QBU*. If the owner of an outbound loss QBU described in paragraph (b)(2) of this section applied an eligible pretransition method with respect to the outbound loss QBU, the pretransition loss with respect to the outbound loss QBU is equal to the outbound section 987 loss that was not added to the basis of stock or recognized under prior §1.987-12 before the transition date with respect to the outbound loss QBU.

(3) *Amount of pretransition gain or loss for an owner that did not apply an eligible pretransition method*—(i) *In general*. If the owner of a section 987 QBU described in paragraph (b)(1) of this section did not apply an eligible pretransition

method with respect to the section 987 QBU, the amount of pretransition gain or loss with respect to the section 987 QBU is determined under paragraph (e)(3)(ii) of this section. *See* paragraph (l)(4) of this section (*Example 4*) for an illustration of this rule.

(ii) *Computation of pretransition gain or loss*. With respect to a section 987 QBU described in paragraph (e)(3)(i) of this section, pretransition gain or loss is equal to the amount described in paragraph (e)(3)(ii)(A) of this section reduced by the amount described in paragraph (e)(3)(ii)(B) of this section.

(A) The sum of the owner's annual unrecognized section 987 gain or loss determined under paragraph (e)(3)(iii) of this section with respect to the section 987 QBU for all taxable years ending before the transition date and beginning after September 7, 2006, in which it was the owner of the section 987 QBU.

(B) The total net amount of section 987 gain or loss recognized by the owner with respect to the section 987 QBU in all taxable years ending before the transition date and beginning after September 7, 2006.

(iii) *Annual unrecognized section 987 gain or loss*. An owner of a section 987 QBU described in paragraph (e)(3)(i) of this section determines annual unrecognized section 987 gain or loss with respect to a section 987 QBU under the rules of §1.987-4(d), applied as though a current rate election was in effect for all relevant taxable years, and subject to the following modifications—

(A) Only §1.987-4(d)(1) and (10) (steps 1 and 10) are applied; and

(B) Section 1.987-4(d)(10) is applied by replacing "paragraphs (d)(1) through (9) of this section" with "paragraph (d)(1) of this section."

(iv) *Deferral QBU owner*. If a deferral QBU owner described in paragraph (b)(2) of this section did not apply an eligible pretransition method with respect to the deferral QBU, the pretransition gain or loss with respect to the deferral QBU is equal to the amount that would be determined under paragraph (e)(3)(ii) of this section with respect to the deferral QBU if the transition date was the day of the deferral event, reduced by the amount of deferred section 987 gain or loss (determined under prior §1.987-12) recognized before the actual transition date.

(v) *Owner of an outbound loss QBU*. If the owner of an outbound loss QBU described in paragraph (b)(2) of this section did not apply an eligible pretransition method with respect to the outbound loss QBU, the pretransition loss with respect to the outbound loss QBU is equal to the amount that would be determined under paragraph (e)(3)(ii) of this section with respect to the outbound loss QBU if the transition date was the day of the outbound loss event, reduced by any outbound section 987 loss recognized or added to the basis of stock under prior §1.987-12 before the actual transition date.

(4) *Eligible pretransition method*. An eligible pretransition method means a method of applying section 987 before the transition date that is described in paragraphs (e)(4)(i) through (iii) of this section. An owner is treated as applying an eligible pretransition method with respect to a section 987 QBU only if it applied an eligible pretransition method with respect to the QBU on a return filed before November 9, 2023.

(i) *Earnings and capital method*. An earnings and capital method is an eligible pretransition method if it is applied in a reasonable manner. For purposes of this paragraph (e)(4)(i), an earnings and capital method means a method of applying section 987 that requires section 987 gain or loss to be determined and recognized with respect to both the earnings of the section 987 QBU and capital contributed to the section 987 QBU (for example, the method prescribed in the 1991 proposed regulations under section 987). *See* paragraph (l)(1) of this section (*Example 1*) for an illustration of this rule.

(ii) *Other reasonable methods*. Any reasonable method of applying section 987 is an eligible pretransition method if it produces the same total amount of income over the life of the owner of a section 987 QBU as the method described in paragraph (e)(4)(i) of this section (taking into account the aggregate of section 987 gain or loss, section 987 taxable income or loss, and income or loss recognized by the owner of the section 987 QBU with respect to property transferred between the section 987 QBU and the owner or any QBU of the owner). *See* paragraph (l)(2) of this section (*Example 2*) for an illustration of this rule.

(iii) *Other earnings only methods*. An earnings only method that does not meet the requirements of paragraph (e)(4)(ii) of this section is an eligible pretransition method, provided that—

(A) The earnings only method was first applied by the owner on a return filed before November 9, 2023;

(B) The earnings only method was applied consistently to all section 987 QBUs of the owner since the first taxable year in which the owner applied an eligible pretransition method; and

(C) The owner of the section 987 QBU otherwise applied section 987 in a reasonable manner. *See* paragraph (l)(3) of this section (*Example 3*) for an illustration of this rule.

(iv) *Error in the application of a section 987 method*. If an owner generally applied section 987 with respect to a section 987 QBU before the transition date under a method described in paragraph (e)(4)(i), (ii), or (iii) of this section but made errors in the application of the method or failed to apply the method to every taxable year since the QBU's inception, the owner is considered to have applied an eligible pretransition method with respect to the QBU. However, pretransition gain or loss must be determined under paragraph (e)(2) of this section as though the eligible pretransition method was applied without error since the section 987 QBU's inception. *See* paragraph (l)(5) of this section (*Example 5*) for an illustration of this rule.

(v) *Certain consistent practices not treated as errors*—(A) *In general*. If an owner generally applied section 987 with respect to a section 987 QBU before the transition date under a method described in paragraph (e)(4)(i), (ii), or (iii) of this section and used a consistent practice described in paragraph (e)(4)(v)(B) of this section for purposes of applying that method, the owner is considered to have applied an eligible pretransition method with respect to the QBU. In addition, the consistent practice is not treated as an error under paragraph (e)(4)(iv) of this section. Therefore, the owner must take the consistent practice into account in determining pretransition gain or loss under paragraph (e)(2) of this section. *See* paragraph (l)(6) of this section (*Example 6*) for an illustration of this rule.

(B) *Practices not treated as errors*—(*1*) *Reasonable conventions*. The use of a reasonable convention (for example, the use of a yearly average exchange rate rather than the applicable spot rate to translate frequently recurring transfers) is a practice described in this paragraph (e)(4)(v)(B).

(*2*) *Disregarded transactions*. If, in determining the amount of a remittance that requires the recognition of gain or loss under section 987(3), an owner of a QBU consistently disregarded certain transfers to or from the QBU (other than transfers from the QBU to the owner that would be treated as distributions if the QBU were treated as a separate corporation), the owner is considered to have applied a practice described in this paragraph (e)(4)(v)(B) with respect to the QBU, provided that the owner otherwise accounts for the disregarded transfers in a reasonable manner (for example, under the method described in the 1991 proposed regulations, by taking the disregarded transfers into account in computing equity and basis pools so as to properly reflect the owner's net equity in the QBU and its functional currency basis in the QBU).

(vi) *Deferral of section 987 gain or loss until termination is not reasonable*. For purposes of this paragraph (e)(4), a method under which the owner of a section 987 QBU defers the recognition of section 987 gain or loss until the section 987 QBU is terminated, sold, or liquidated is not a reasonable method.

(vii) *Anti-abuse rule*. If an owner changes its pretransition method of applying section 987 with a principal purpose of reducing its pretransition gain or increasing its pretransition loss, the Commissioner may redetermine pretransition gain or loss based on the owner's original method of applying section 987 or by treating the owner as not applying an eligible pretransition method.

(5) *Recognition of pretransition gain or loss*—(i) *In general*. Except as provided in paragraph (e)(5)(ii) of this section, pretransition gain is recognized under paragraph (e)(5)(i)(A) of this section and pretransition loss is recognized under paragraph (e)(5)(i)(B) of this section.

(A) *Pretransition gain*. Pretransition gain with respect to a section 987 QBU is treated as net accumulated unrecognized section 987 gain (within the meaning of §1.987-4(c)). Pretransition gain with respect to a deferral QBU is treated as deferred section 987 gain and is attributed to one or more successor deferral QBUs under the principles of §1.987-12(b)(2) and (c)(2).

(B) *Pretransition loss*—(*1*) *In general*. Except as provided in paragraph (e)(5)(i)(B)(*2*) of this section, pretransition loss with respect to a section 987 QBU, a deferral QBU, or an outbound loss QBU is treated as suspended section 987 loss with respect to the section 987 QBU, the deferral QBU, or the outbound loss QBU. In the case of a deferral QBU or outbound loss QBU, suspended section 987 loss is attributed to one or more successor suspended loss QBUs under the principles of §1.987-13(b)(1) and (c)(1).

(*2*) *Current rate election*. If a current rate election is in effect (and an annual recognition election is not in effect) in the taxable year beginning on the transition date, pretransition loss with respect to a section 987 QBU (other than a terminating QBU) is treated as net accumulated unrecognized section 987 loss (within the meaning of §1.987-4(c)), and pretransition loss with respect to a deferral QBU is treated as deferred section 987 loss and is attributed to one or more successor deferral QBUs under the principles of §1.987-12(b)(2) and (c)(2).

(ii) *Election to recognize pretransition section 987 gain or loss ratably over the transition period*—(A) *In general*. A taxpayer may elect to recognize pretransition gain or loss ratably over the transition period. If an election is made to recognize pretransition gain or loss ratably over the transition period, then paragraph (e)(5)(i) of this section does not apply, and each owner to which the election applies recognizes one tenth of its pretransition gain or loss with respect to each section 987 QBU, original deferral QBU, and outbound loss QBU in each taxable year for ten taxable years beginning with the taxable year that begins on the transition date described in paragraph (c)(1) of this section. *See* §1.987-1(g) for rules relating to section 987 elections (including consistency rules).

(B) *Special rules for certain transactions*—(*1*) *Scope*. This paragraph (e)(5)(ii)(B) applies if a corporation (*acquiring corporation*) acquires the assets of an owner that is subject to an election under paragraph (e)(5)(ii)(A) of this section in a transaction described in section 381(a), and either the owner is a foreign corporation and the acquiring corporation is a domestic corporation or the owner is a domestic corporation and the acquiring corporation is a foreign corporation. This paragraph (e)(5)(ii)(B) also applies to any transaction entered into with a principal purpose of avoiding the recognition of pretransition gain under paragraph (e)(5)(ii)(A) of this section.

(*2*) *Recognition of pretransition gain or loss*. In the case of a transaction described in paragraph (e)(5)(ii)(B)(*1*) of this section, pretransition gain or loss that has not been recognized under paragraph (e)(5)(ii)(A) of this section ceases to be subject to the election to be recognized ratably over the transition period. Any unrecognized pretransition gain is recognized immediately before the transaction, and any unrecognized pretransition loss becomes suspended section 987 loss immediately before the transaction. As a result, the suspended section 987 loss may be recognized to the extent of section 987 gain recognized in the same recognition grouping pursuant to §1.987-11(e). *See also* §1.987-13(g) (providing that any remaining suspended section 987 loss does not carry over to the acquiring corporation upon an inbound transaction to which section 381(a) applies).

(C) *Terminating QBU*. This paragraph (e)(5)(ii)(C) applies with respect to a terminating QBU if, in the taxable year beginning on the transition date described in paragraph (c)(1) of this section, the owner of the terminating QBU elects to recognize pretransition gain or loss ratably over the transition period. Any deferred section 987 gain or loss or suspended section 987 loss with respect to the terminating QBU that was not recognized before the transition date described in paragraph (c)(1) of this section is treated as pretransition gain or loss for purposes of this paragraph (e)(5)(ii) (and ceases to be treated as deferred section 987 gain or loss or suspended section 987 loss). The pretransition gain or loss is recognized ratably over ten taxable years beginning with the taxable year that begins on the transition date described in paragraph (c)(1) of this section.

(6) *Predecessor of an owner*—(i) *In general*. For purposes of this paragraph (e), references to an owner of a section 987 QBU, a deferral QBU owner, and the owner of an outbound loss QBU include a predecessor described in paragraph (e)(6)(ii) of this section.

(ii) *Predecessor*. If a corporation (*acquiring corporation*) becomes the owner of a section 987 QBU in a transaction described in section 381(a) in which the section 987 QBU does not terminate, the corporation that was the owner of the section 987 QBU immediately before the transaction is a predecessor of the acquiring corporation. If a corporation (*acquiring corporation*) becomes a qualified successor of a deferral QBU owner or the owner of an outbound loss QBU (each, a *transferor corporation*), the transferor corporation is a predecessor of the acquiring corporation. A predecessor of a corporation includes the predecessor of a predecessor of the corporation.

(7) *Small business election*—(i) *Scope*. This paragraph (e)(7) applies if the owner of a QBU meets the threshold described in paragraph (e)(7)(ii) of this section and the QBU meets the threshold described in paragraph (e)(7)(iii) of this section. This paragraph (e)(7) does not apply with respect to a terminating QBU.

(ii) *Owner threshold*. An owner of a QBU meets the requirements of this paragraph (e)(7)(ii) if the owner would qualify for the small business exemption provided in section 163(j)(3) for the taxable year beginning on the transition date described in paragraph (c)(1) of this section.

(iii) *QBU threshold*. A QBU meets the requirements of this paragraph (e)(7)(iii) if the assets attributable to the QBU have an adjusted basis (translated at the spot rate applicable to the last day of each taxable year) of $10 million or less at the end of each of the three taxable years of the owner ending before the transition date described in paragraph (c)(1) of this section (or, if the QBU was not in existence for three taxable years, each taxable year ending before the transition date in which the QBU existed). For this purpose, all QBUs owned by members of the same controlled group that have the same country of residence (as defined in section 988(a)(3)(B)) are treated as a single QBU. Solely for purposes of applying this paragraph (e)(7)(iii) in the case of a deferral QBU or outbound loss QBU described in paragraph (b)(2) of this section, the termination date is treated as the transition date.

(iv) *Small business election*. If the owner of a QBU meets the requirements of paragraph (e)(7)(ii) of this section, the owner may elect to treat all QBUs that meet the requirements of paragraph (e)(7)(iii) of this section as having no pretransition gain or loss.

(f) *QBUs to which the fresh start transition method was applied*—(1) *In general*. Paragraphs (d) and (e) of this section do not apply with respect to any section 987 QBU, deferral QBU, or outbound loss QBU with respect to which the taxpayer applied the rules of prior §1.987-10 (or applied §1.987-10 of the 2006 proposed regulations in a reasonable manner) on a return filed before November 9, 2023 or pursuant to paragraph (f)(3) of this section.

(2) *Application of the section 987 regulations after the transition date*—(i) *Owner functional currency net value on the last day of the preceding taxable year*. For purposes of applying §1.987-4 with respect to a section 987 QBU described in paragraph (f)(1) of this section for the taxable year beginning on the transition date, the owner functional currency net value of the section 987 QBU on the last day of the preceding taxable year under §1.987-4(d)(1)(i)(B) is the amount that was determined for the preceding taxable year under prior §1.987-4(d)(1)(A) or §1.987-4(d)(1)(A) of the 2006 proposed section 987 regulations, as applicable.

(ii) *Determination of historic rate*. For purposes of applying the section 987 regulations with respect to historic items (other than inventory subject to the simplified inventory method under §1.987-3(c)(2)(iv)(A)) that are attributable to the section 987 QBU on the day before the transition date, a taxpayer must use the same historic rates as were used under the taxpayer's application of the 2016 and 2019 section 987 regulations or the 2006 proposed section 987 regulations, as applicable, in place of the historic rates that otherwise would be determined under §1.987-1(c)(3).

(iii) *Unrecognized section 987 gain or loss*—(A) *Net accumulated unrecognized section 987 gain or loss of a section 987 QBU*. In taxable years beginning on or after the transition date, for purposes of calculating the net accumulated unrecognized section 987 gain or loss of a section 987 QBU described in paragraph (f)(1) of this section under §1.987-4(c)—

(*1*) Amounts determined under prior §1.987-4(d) or under §1.987-4(d) or §1.987-10 of the 2006 proposed section 987 regulations, as applicable, are included in amounts determined under §1.987-4(d) for all prior taxable years; and

(*2*) Amounts taken into account under prior §1.987-5(a) or under §1.987-5(a) of the 2006 proposed section 987 regulations, as applicable, are included in amounts recognized under §1.987-5(a) for all prior taxable years. For this purpose, amounts taken into account under prior §1.987-5(a) or under §1.987-5(a) of the 2006 proposed section 987 regulations, as applicable, are determined without regard to prior §1.987-12 or prior §1.987-12T.

(B) *Deferred section 987 gain or loss attributable to a successor deferral QBU*. In the taxable year beginning on the transition date, the outstanding deferred section 987 gain or loss (as determined under prior §1.987-12) of a deferral QBU described in paragraph (f)(1) of this section becomes deferred section 987 gain or loss (within the meaning of §1.987-12). The deferred section 987 gain or loss is attributed to one or more successor deferral QBUs under the principles of §1.987-12(b)(2) and (c)(2).

(C) *Outbound section 987 loss attributable to a successor suspended loss QBU*. In the taxable year beginning on the transition date, outbound section 987 loss of an outbound loss QBU described in paragraph (f)(1) of this section that has not been recognized or added to the basis of stock under prior §1.987-12 becomes suspended section 987 loss. The suspended section 987 loss is attributed to one or more successor suspended loss QBUs under the principles of §1.987-13(b)(1) and (c)(1).

(3) *Taxpayers that are required to transition using the fresh start transition method*. If a taxpayer is subject to a consent agreement under which it is required to apply the fresh start transition method with respect to a section 987 QBU, then the taxpayer must apply the transition rules of prior §1.987-10 to that section 987 QBU for the taxable year beginning on the transition date and immediately before the taxpayer applies

this section. In applying this section, the taxpayer is treated as having applied prior §1.987-10 to the section 987 QBU.

(g) [Reserved]

(h) *Determination of source and character*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, the source and character of pretransition gain or loss is determined under the rules of §1.987-6. *See* §1.987-6(b)(1) (timing of source and character determination).

(2) *Deferral QBU or outbound loss QBU*. Notwithstanding paragraph (h)(1) of this section and §1.987-6, the source and character of pretransition gain or loss with respect to a deferral QBU or an outbound loss QBU described in paragraph (b)(2) of this section is the same as the source and character of the outstanding deferred section 987 gain or loss (determined under prior §1.987-12) of the deferral QBU or the outbound section 987 loss of the outbound loss QBU (determined under prior §1.987-12(e)).

(i) [Reserved]

(j) *Adjustments to avoid double counting or omissions*. If a difference between the treatment of any item under the section 987 regulations and the treatment of the item under the taxpayer's prior section 987 method would result in income, gain, deduction, or loss (including section 988 gain or loss) being taken into account more than once or not being taken into account, then pretransition gain or loss, as determined under paragraphs (e)(2) and (3) of this section, is adjusted to account for the difference. In case of a QBU described in paragraph (f)(1) of this section, appropriate adjustments must be made under the principles of paragraph (e)(5) of this section. In the case of a terminating QBU, the determination as to whether an adjustment is required under this paragraph (j) is made after taking into account section 988 gain or loss recognized in connection with the termination.

(k) *Reporting*—(1) *In general*. Except as otherwise provided in this paragraph (k), a statement titled "Section 987 Transition Information" must be attached to an owner's timely filed (including extensions) return for the taxable year beginning on the transition date providing the following information for each QBU described in paragraph (k)(2) of this section:

(i) A description of each QBU, the QBU's principal place of business, and a description of the prior method used by the taxpayer to determine its section 987 gain or loss, deferred section 987 gain or loss, or outbound section 987 loss with respect to the QBU, including an explanation as to whether such method was an eligible pretransition method.

(ii) The pretransition gain or loss with respect to each QBU and the computations used to determine pretransition gain or loss.

(iii) Whether the authorized person has elected to recognize pretransition gain or loss ratably over the transition period pursuant to paragraph (e)(5)(ii) of this section.

(iv) Whether the authorized person has made a small business election under paragraph (e)(7) of this section and the computations used to determine eligibility for the election.

(v) With respect to each QBU for which any adjustment is made under paragraph (j) of this section, a description of each adjustment and the basis for computing the adjustment.

(vi) A list of the QBUs described in paragraph (f)(1) of this section, or a statement that no QBUs are described in paragraph (f)(1) of this section.

(2) *QBUs for which reporting is required*—(i) *In general*. Except as provided in paragraph (k)(2)(ii) of this section, the information described in paragraph (k)(1) of this section must be provided with respect to—

(A) Each section 987 QBU described in paragraph (b)(1) of this section;

(B) Each deferral QBU described in paragraph (b)(2) of this section and each of its successor deferral QBUs; and

(C) Each outbound loss QBU described in paragraph (b)(2) of this section and each of its successor suspended loss QBUs.

(ii) *QBUs to which the fresh start transition method was applied*. A taxpayer is not required to provide the information described in paragraphs (k)(1)(i) through (iv) of this section with respect to a QBU described in paragraph (f)(1) of this section.

(3) *Attachments not required where information is reported on a form*. This paragraph (k) does not apply to the extent provided on a form or instructions published by the Commissioner.

(4) *No change in method of accounting*. The application of this section is not treated as a change in method of accounting for purposes of sections 446 and 481.

(l) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, DC is a domestic corporation with the U.S. dollar as its functional currency and Branch is a section 987 QBU with the euro as its functional currency. DC has a taxable year ending December 31, and the transition date is January 1, year 4. For purposes of the examples, except as otherwise indicated, assume that no section 987 elections are in effect.

(1) *Example 1: Earnings and capital method*—(i) *Facts*—(A) *Formation of Branch and Branch's operations*. DC formed Branch on November 30, year 1, with a contribution of €150. In year 1, Branch purchased a parcel of unimproved land for €100. In year 2, Branch earned €25. In year 3, Branch again earned €25. On June 30, year 3, Branch distributed €100 cash to DC, and DC immediately exchanged the €100 for $135.

(B) *Exchange rates*. The relevant exchange rates are shown below.

Table 1 to paragraph (l)(1)(i)(B)
Exchange Rates

	Spot Rate	Yearly Average Exchange Rate
November 30, Year 1	€1 = $1	
December 31, Year 1	€1 = $1.10	
December 31, Year 2	€1 = $1.20	
June 30, Year 3	€1 = $1.35	
December 31, Year 3	€1 = $1.40	
Year 1		€1 = $1.05
Year 2		€1 = $1.15
Year 3		€1 = $1.25

(C) *Pretransition method*. DC used the method prescribed in the 1991 proposed regulations under section 987 with respect to Branch before the transition date. Under this method, DC maintains an equity pool in euros (Branch's functional currency) and a basis pool in U.S. dollars (DC's functional currency). When Branch makes a remittance (whether out of earnings or capital), DC recognizes section 987 gain or loss equal to the difference between the amount of the remittance (translated into U.S. dollars at the spot rate on the date of the remittance) and the portion of the basis pool attributable to the remittance. DC's basis in assets distributed from Branch is equal to Branch's basis in the assets, translated into U.S. dollars at the spot rate on the date of the remittance. Branch's earnings are translated into U.S. dollars at the average exchange rate for the taxable year. DC otherwise applies section 987 in a reasonable manner.

(D) *Application of the pretransition method before the transition date*. For purposes of determining section 987 gain or loss recognized as a result of the June 30, year 3, remittance, DC was required to determine the amount in Branch's equity and basis pools. Branch's equity pool was equal to €200, and its basis pool was equal to $210, as shown in the table below. Because the remittance was equal to 50% of the equity pool (€100), 50% of the basis pool, or $105, was attributable to the remittance. The amount of the remittance was $135 (€100 translated at the spot rate on June 30, year 3, of €1 = $1.35). Therefore, in year 3, DC recognized section 987 gain of $30, equal to the difference between the amount of the remittance ($135) and the portion of the basis pool attributable to the remittance ($105). As a result of the remittance, the equity pool was reduced by the amount distributed (€100), and the basis pool was reduced by the portion of the basis pool attributable to the remittance ($105). Therefore, after the remittance, the equity pool was equal to €100, and the basis pool was equal to $105. In the hands of DC, the euros distributed had a basis of $135 (equal to the €100 distribution translated at the spot rate on June 30, year 3, of €1 = $1.35). DC did not recognize section 988 gain or loss when it exchanged the euros for $135.

Table 2 to paragraph (l)(1)(i)(D)
Year 3 Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Contribution (11/30/Year 1)	€150	€1 = $1	$150
Year 2 Earnings	€25	€1 = $1.15	$28.75
Year 3 Earnings	€25	€1 = $1.25	$31.25
Total	€200		$210

(ii) *Analysis*—(A) *DC's method is an eligible pretransition method*. Before the transition date, DC followed the method prescribed in the 1991 proposed regulations under section 987 with respect to Branch. This method is an eligible pretransition method under paragraph (e)(4)(i) of this section. Therefore, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(B) *Pretransition gain or loss*. Under paragraph (e)(2) of this section, DC's pretransition gain or loss with respect to Branch is equal to the sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. As explained in paragraphs (l)(1)(ii)(B)(*1*) and (*2*) of this section (*Example 1*), DC's deemed termination amount is $35 and its owner functional currency net value adjustment is zero. Therefore, DC has $35 of pretransition gain with respect to Branch. Under paragraph (e)(5)(i)(A) of this section, the pretransition gain is treated as Branch's net accumulated unrecognized section 987 gain. However, if DC elects to recognize its pretransition gain ratably over the transition period under paragraph (e)(5)(ii) of this section, the pretransition gain is not treated as net accumulated unrecognized section 987 gain. Instead, DC recognizes $3.50 (one tenth of its pretransition gain) for each of the ten taxable years from year 4 through year 13.

(*1*) *Deemed termination amount*. Under paragraph (e)(2)(i)(A) of this section, the deemed termination amount is the amount of section 987 gain or loss that would have been recognized by DC under the eligible pretransition method if Branch terminated and transferred all its assets and liabilities to DC (the land with a basis of €100) on December 31, year 3. Under DC's eligible pretransition method, DC would have recognized section 987 gain of $35, determined by subtracting the remaining basis pool of $105 from the amount of the remittance of $140 (€100 translated at the spot rate on December 31, year 3, of €1 = $1.40). Therefore, the deemed termination amount is $35.

(*2*) *Owner functional currency net value adjustment*. On December 31, year 3, Branch had no liabilities and only one asset: land with a basis of €100. Under paragraph (e)(2)(i)(B) of this section, the owner functional currency net value adjustment is equal to the basis of the land, translated into U.S. dollars at the transition exchange rate, reduced by the basis of the land, translated into U.S. dollars at the pretransition translation rate. Under paragraph (d)(3)(i) of this section, the transition exchange rate is the spot rate applicable to December 31, year 3. Under paragraph (e)(2)(i)(C) of this section, the pretransition translation rate is the rate that would be used under DC's eligible pretransition method to determine the basis of the land in the hands of DC if Branch transferred the land to DC on December 31, year 3. Under DC's eligible pretransition method, if Branch transferred the land to DC, DC's basis in the land would be equal to Branch's basis (€100) translated at the spot rate on the date of the remittance. Therefore, the pretransition translation rate on December 31, year 3, is equal to the spot rate on December 31, year 3. Consequently, the owner functional currency net value adjustment is zero.

(C) *Determination of unrecognized section 987 gain or loss in year 4*. For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the transition exchange rate, which is the spot rate on December 31, year 3 (€1 = $1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is $140.

(2) *Example 2: Earnings only method described in paragraph (e)(4)(ii) of this section*—(i) *Facts*—(A) *In general*. The facts and exchange rates are the same as in paragraph (l)(1) of this section (*Example 1*), except that DC uses an earnings only method with respect to Branch before the transition date, as described in paragraph (l)(2)(i)(B) of this section. In addition, a current rate election is in effect for Year 4.

(B) *Pretransition method*. Under the earnings only method, DC maintains an equity pool in euros (Branch's functional currency) and a basis pool in U.S. dollars (DC's functional currency) with respect to Branch's earnings. DC also maintains separate equity and basis pools with respect to Branch's capital. Distributions are treated as being made first out of earnings and then out of capital. When Branch makes a remittance out of earnings, DC recognizes section 987 gain or loss equal to the difference between the amount of the remittance (translated into U.S. dollars at the spot rate on the date of the remittance) and the portion of the earnings basis pool attributable to the remittance. No section 987 gain or loss is recognized on a distribution out of capital. DC's basis in assets distributed out of Branch's earnings is equal to Branch's basis in the assets translated at the spot rate on the date of the remittance. DC's basis in assets distributed out of Branch's capital is equal to the portion of the capital basis pool attributable to the distribution. Branch's earnings are translated into U.S. dollars at the average exchange rate for the taxable year. DC otherwise applies section 987 in a reasonable manner.

(C) *Application of the pretransition method before the transition date*. On June 30, year 3, Branch distributed €100 cash to DC. Of this amount, €50 represented a remittance out of earnings, and €50 represented a distribution out of capital.

(*1*) *Remittance out of earnings*. For purposes of determining section 987 gain or loss recognized on the remittance, Branch's earnings equity pool was equal to €50, and its earnings basis pool was equal to $60, as shown in the table below. Because Branch remitted 100% of the earnings equity pool (€50), the entire earnings basis pool, or $60, was attributable to the remittance. The value of the remittance was $67.50 (€50 translated at the spot rate on June 30, year 3, of €1 = $1.35). Therefore, in year 3, DC recognized section 987 gain of $7.50, equal to the difference between the value of the remittance ($67.50) and the portion of the basis pool attributable to the remittance ($60). As a result of the remittance, the earnings equity pool and the earnings basis pool were each reduced to zero. In the hands of DC, the €50 distributed out of earnings had a basis of $67.50 (€50 translated at the spot rate on June 30, year 3, of €1 = $1.35).

Table 3 to paragraph (l)(2)(i)(C)(*1*)
Earnings Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Year 2 Earnings	€25	€1 = $1.15	$28.75
Year 3 Earnings	€25	€1 = $1.25	$31.25
Total	€50		$60

(*2*) *Distribution out of capital*. The basis of the €50 distributed out of capital was equal to the portion of the capital basis pool attributable to the distribution. For this purpose, the capital equity pool was equal to €150, and the capital basis pool was equal to $150, as shown in the table below. Because Branch distributed 33% of the capital equity pool, or €50, 33% of the capital basis pool, or $50, was attributable to the distribution. In the hands of DC, the €50 distributed out of capital had a basis of $50. As a result of the capital distribution, the capital equity pool was reduced to €100 and the capital basis pool was reduced to $100.

Table 4 to paragraph (l)(2)(i)(C)(*2*)
Capital Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Contribution (11/30/Year 1)	€150	€1 = $1	$150
Total	€150		$150

(*3*) *Section 988 gain recognized*. On June 30, year 3, DC exchanged €100 with an aggregate basis of $117.50 (equal to the sum of the $67.50 basis of the remittance out of earnings and the $50 basis of the distribution out of capital) for $135. Therefore, DC recognized $17.50 of gain under section 988.

(ii) *Analysis*—(A) *DC's method is an eligible pretransition method*. Before the transition date, DC followed a reasonable method of applying section 987 that would result in the same total amount of income over the life of DC ($125) as an earnings and capital method, as explained in paragraphs (l)(2)(ii)(A)(*1*) and (*2*) of this section (*Example 2*). Therefore, this method is an eligible pretransition method under paragraph (e)(4)(ii) of this section. Consequently, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(*1*) *DC's total amount of income under its pretransition method*. Under DC's pretransition method, DC recognized $7.50 of section 987 gain and $17.50 of section 988 gain in year 3. In addition, on December 31, year 3, DC had $40 of embedded gain in its capital equity and basis pools (equal to the difference between its capital equity pool of €100, translated at the spot rate on December 31, year 3, of €1 = $1.40, and its capital basis pool of $100) which will be taken into account in the future (when Branch distributes property out of capital and the property is sold). DC also recognized $60 of earnings with respect to Branch ($28.75 in year 2 and $31.25 in year 3). Thus, DC's total income (recognized and unrecognized) with respect to Branch is $125.

(*2*) *DC's total amount of income under an earnings and capital method*. If DC had instead applied an earnings and capital method, as described in paragraph (l)(1)(i)(C) of this section (*Example 1*), DC would have recognized section 987 gain of $30 in year 3 and would not have recognized section 988 gain in year 3, as explained in paragraph (l)(1)(i)(D) of this section. On December 31, year 3, DC would have unrecognized section 987 gain in its equity and basis pools of $35 (*see* paragraph (l)(1)(ii)(B)(*1*) of this section (*Example 1*)). DC would also have recognized $60 of earnings with respect to Branch ($28.75 in year 2 and $31.25 in year 3). Thus, DC's total income (recognized and unrecognized) with respect to Branch is $125.

(B) *Pretransition gain or loss*. Under paragraph (e)(2) of this section, DC's pretransition gain or loss with respect to Branch is equal to sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. As explained in paragraphs (l)(2)(ii)(B)(*1*) and (*2*) of this section (*Example 2*), the deemed termination amount is zero and the owner functional currency net value adjustment is $40. Therefore, DC has $40 of pretransition gain with respect to Branch. Under paragraph (e)(5)(i)(A) of this section, the pretransition gain is treated as Branch's net accumulated unrecognized section 987 gain. However, if DC elects to recognize its pretransition gain ratably over the transition period under paragraph (e)(5)(ii) of this section, the pretransition gain is not treated as net accumulated unrecognized section 987 gain. Instead, DC recognizes $4 (one tenth of its pretransition gain) for each of the ten taxable years from year 4 through year 13.

(*1*) *Deemed termination amount*. Under paragraph (e)(2)(i)(A) of this section, the deemed termination amount is the amount of section 987 gain or loss that would have been recognized by DC under the eligible pretransition method if Branch terminated and transferred all of its assets and liabilities to DC on December 31, year 3. Under DC's eligible pretransition method, if Branch had transferred all of its assets and liabilities to DC, this would have been treated as a distribution out of capital. Under its eligible pretransition method, DC would not have recognized section 987 gain or loss on a distribution out of capital. Therefore, the deemed termination amount is zero.

(*2*) *Owner functional currency net value adjustment*. On December 31, year 3, Branch had no liabilities and only one asset: land with a basis of €100. Under paragraph (e)(2)(i)(B) of this section, the owner functional currency net value adjustment is equal to the basis of Branch's land, translated into U.S. dollars at the transition exchange rate, reduced by the basis of Branch's land, translated into U.S. dollars at the pretransition translation rate on December 31, year 3. Under paragraph (e)(2)(i)(C) of this section, the pretransition translation rate is the rate that would be used under the eligible pretransition method to determine the basis of the land in the hands of DC if Branch transferred the land to DC. Under DC's eligible pretransition method, DC's basis in assets distributed from Branch is equal to the portion of the capital basis pool attributable to the distribution. If Branch transferred the land with a basis of €100 to DC on December 31, year 3, its remaining capital basis pool of $100 would be attributable to the distribution, and the land would have a basis of $100 in the hands of DC. Because the land had a basis of €100 in the hands of Branch, and would have a basis of $100 in the hands of DC if it were distributed on December 31, year 3, the pretransition translation rate is €1 = $1. Under paragraph (d)(3)(i) of this section, because a current rate election is in effect for year 4, the transition exchange rate is the spot rate applicable to December 31, year 3. The €100 basis of Branch's land, translated at the spot rate on December 31, year 3 of €1 = $1.40 is equal to $140. The €100 basis of Branch's land, translated at the pretransition translation rate on December 31, year 3 of €1 = $1 is equal to $100. Therefore, the owner functional currency net value adjustment is equal to $40 ($140 - $100).

(C) *Determination of unrecognized section 987 gain or loss in year 4*. For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the transition exchange rate, which is the spot rate on December 31, year 3 (€1 = $1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is $140.

(iii) *Alternative facts*—(A) *No current rate election*. Assume the facts are the same as described in paragraph (l)(2)(i) of this section (*Example 2*), except that a current rate election is not in effect for year 4.

(B) *Analysis*. As explained in paragraph (l)(2)(ii)(A) of this section (*Example 2*), DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section. Because a current rate election is not in effect, the transition exchange rate is determined under paragraph (d)(3)(ii) of this section.

(*1*) *Transition exchange rate*. DC applied an earnings only method described in paragraph (e)(4)(ii) of this section before the transition date. Under paragraph (d)(3)(ii) of this section, because a current rate election is not in effect for year 4, the transition exchange rate for Branch's land is equal to the pretransition translation rate. As explained in paragraph (l)(2)(ii)(B)(*2*) of this section (*Example 2*), the pretransition translation rate is €1 = $1.

(*2*) *Pretransition gain or loss*. Because the transition exchange rate for the land (Branch's sole asset) is equal to the pretransition translation rate, the owner functional currency net value adjustment is zero. As explained in paragraph (l)(2)(ii)(B)(*1*) of this section (*Example 2*), the deemed termination amount is also zero. Therefore, DC has no pretransition gain or loss with respect to Branch.

(*3*) *Determination of unrecognized section 987 gain or loss in year 4*. For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the transition exchange rate, which is the pretransition translation rate of €1 = $1. Therefore, the owner functional currency net value of Branch on the last day of year 3 is $100.

(3) *Example 3: Earnings only method described in paragraph (e)(4)(iii) of this section*—(i) *Facts*—(A) *In general*. The facts and exchange rates are the same as in paragraph (l)(1) of this section (*Example 1*), except that DC used an earnings only method with respect to Branch before the transition date, as described in paragraph (l)(3)(i)(B) of this section.

(B) *Pretransition method*. Under the earnings only method, DC maintains an equity pool in euros (Branch's functional currency) and a basis pool in U.S. dollars (DC's functional currency) with respect to Branch's earnings. However, DC does not maintain separate equity and basis pools with respect to Branch's capital. Distributions are treated as being made first out of earnings and then out of capital. When Branch makes a remittance out of earnings, DC recognizes section 987 gain or loss equal to the difference between the amount of the remittance (translated into U.S. dollars at the spot rate on the date of the remittance) and the portion of the earnings basis pool attributable to the remittance. No section 987 gain or loss is recognized on a distribution out of capital. Under DC's pretransition method, DC's basis in assets distributed by Branch (whether out of earnings or capital) is equal to Branch's basis in the assets translated at the spot rate on the date of the distribution. Branch's earnings are translated into U.S. dollars at the average exchange rate for the taxable year. DC first applied its earnings only method on a return filed before November 9, 2023. In addition, DC applied its earnings only method consistently to all of its section 987 QBUs and otherwise applied section 987 in a reasonable manner.

(C) *Application of the pretransition method before the transition date*. On June 30, year 3, Branch distributed €100 cash to DC. Of this amount, €50 represented a remittance out of earnings, and €50 represented a distribution out of capital.

(*1*) *Remittance out of earnings*. For purposes of determining section 987 gain or loss recognized on the remittance, Branch's earnings equity pool was equal to €50, and its earnings basis pool was equal to $60, as shown in the table below. Because Branch remitted 100% of the earnings equity pool (€50), the entire earnings basis pool, or $60, was attributable to the remittance. The value of the remittance was $67.50 (€50 translated at the spot rate on June 30, year 3, of €1 = $1.35). Therefore, in year 3, DC recognized section 987 gain of $7.50, equal to the difference between the value of the remittance ($67.50) and the portion of the basis pool attributable to the remittance ($60). As a result of the remittance, the earnings equity pool and the earnings basis pool were each reduced to zero.

Table 5 to paragraph (l)(3)(i)(C)(*1*)
Earnings Equity and Basis Pools

	Equity Pool	Translation Rate	Basis Pool
Year 2 Earnings	€25	€1 = $1.15	$28.75
Year 3 Earnings	€25	€1 = $1.25	$31.25
Total	€50		$60

(*2*) *Basis of euros distributed*. In the hands of DC, the €100 distributed had a basis of $135 (€100 translated at the spot rate on June 30, year 3, of €1 = $1.35). DC did not recognize gain or loss under section 988 when it exchanged the €100 for $135.

(ii) *Analysis*—(A) *DC's method is an eligible pretransition method*. Unlike in paragraph (l)(2) of this section (*Example 2*), DC's earnings only method would not result in the same total amount of income over the life of DC as an earnings and capital method described in paragraph (e)(4)(i) of this section because DC does not maintain capital basis and equity pools and DC translates the basis of all property distributed from Branch at the spot rate on the distribution date. However, this method is an eligible pretransition method under paragraph (e)(4)(iii) of this section because DC first applied its earnings only method on a return filed before November 9, 2023, DC applied its earnings only method consistently to all of its section 987 QBUs, and DC otherwise applied section 987 in a reasonable manner. Consequently, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(B) *Pretransition gain or loss*. Under paragraph (e)(2) of this section, DC's pretransition gain or loss with respect to Branch is equal to the sum of the deemed termination amount described in paragraph (e)(2)(i)(A) of this section and the owner functional currency net value adjustment described in paragraph (e)(2)(i)(B) of this section. As explained in paragraphs (l)(3)(ii)(B)(*1*) and (*2*) of this section (*Example 3*), the deemed termination amount is zero and the owner functional currency net value adjustment is zero. Therefore, DC has no pretransition gain or loss with respect to Branch.

(*1*) *Deemed termination amount*. Under paragraph (e)(2)(i)(A) of this section, the deemed termination amount is the amount of section 987 gain or loss that would have been recognized by DC under the eligible pretransition method if Branch terminated and transferred all of its assets and liabilities to DC on December 31, year 3. Under DC's eligible pretransition method, if Branch had transferred all of its assets and liabilities to DC, it would have been treated as a distribution out of capital. Under its eligible pretransition method, DC would not have recognized section 987 gain or loss on a distribution out of capital. Therefore, the deemed termination amount is zero.

(*2*) *Owner functional currency net value adjustment*. On December 31, year 3, Branch has no liabilities and only one asset: land with a basis of €100. Under paragraph (e)(2)(i)(B) of this section, the owner functional currency net value adjustment is equal to the basis of the land, translated into U.S. dollars at the transition exchange rate, reduced by the basis of the land, translated into U.S. dollars at the pretransition translation rate. Under paragraph (d)(3)(i) of this section, the transition exchange rate is the spot rate applicable to December 31, year 3. Under paragraph (e)(2)(i)(C) of this section, the pretransition translation rate is the rate that would be used under DC's eligible pretransition method to determine the basis of the land in the hands of DC if Branch transferred the land to DC on December 31, year 3. Under DC's eligible pretransition method, if Branch transferred the land to DC, DC's basis in the land would be equal to Branch's basis (€100) translated at the spot rate on the date of the distribution. Therefore, the pretransition translation rate on December 31, year 3, is equal to the spot rate on December 31, year 3. Consequently, the owner functional currency net value adjustment is zero.

(C) *Determination of unrecognized section 987 gain or loss in year 4*. For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the spot rate on December 31, year 3 (€1 = $1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is $140.

(4) *Example 4: Owner did not apply section 987(3)*—(i) *Facts*. The facts and exchange rates are the same as in paragraph (l)(1) of this section (*Example 1*), except that DC did not apply section 987(3) with respect to Branch and did not recognize section 987 gain or loss with respect to Branch before the transition date.

(ii) *Analysis*—(A) *DC's method is not an eligible pretransition method*. Because DC did not apply section 987(3) with respect to Branch before the transition date, DC did not apply an eligible pretransition method under paragraph (e)(4) of this section. Therefore, DC determines pretransition gain or loss under paragraph (e)(3) of this section.

(B) *Pretransition gain or loss*. Under paragraph (e)(3) of this section, DC's pretransition gain or loss with respect to Branch is equal to the annual unrecognized section 987 gain or loss with respect to Branch for all taxable years ending before the transition date in which DC was the owner of Branch (that is, years 1 through 3), reduced by section 987 gain or loss recognized by DC before the transition date. As explained in paragraphs (l)(4)(ii)(C) through (E) of this section (*Example 4*), DC's annual unrecognized section 987 gain for year 1 is $7.50, DC's annual unrecognized section 987 gain for year 2 is $16.25, and DC's annual unrecognized section 987 gain for year 3 is $23.75. DC did not recognize any section 987 gain or loss with respect to Branch before the transition date. Therefore, DC has $47.50 of pretransition gain with respect to Branch. Under paragraph (e)(5)(i)(A) of this section, the pretransition gain is treated as Branch's net accumulated unrecognized section 987 gain. However, if DC elects to recognize its pretransition gain ratably over the transition period under paragraph (e)(5)(ii) of this section, the pretransition gain is not treated as net accumulated unrecognized section 987 gain. Instead, DC recognizes $4.75 (one tenth of its pretransition gain) for each of the ten taxable years from year 4 through year 13.

(C) *Annual unrecognized section 987 gain or loss for year 1*. Under paragraph (e)(3)(iii) of this section, annual unrecognized section 987 gain or loss with respect to a section 987 QBU is determined under the rules of §1.987-4(d), applied as though a current rate election was in effect for all relevant taxable years (such that all items are treated as marked items), but modified so that only §§1.987-4(d)(1) (change in owner functional currency net value) and 1.987-4(d)(10) (adjustment for residual increase or decrease to net assets) are applied. As explained in paragraphs (l)(4)(ii)(C)(*1*) and (*2*) of this section (*Example 4*), in year 1, the change in owner functional currency net value under §1.987-4(d)(1) is an increase of $165, and there is a negative adjustment of $157.50 under §1.987-4(d)(10). Therefore, DC's annual unrecognized section 987 gain for year 1 is $7.50.

(*1*) *Change in owner functional currency net value for year 1*. On December 31, year 1, Branch held land with a basis of €100 and €50 cash. Therefore, on the last day of year 1, Branch's owner functional currency net value is $165 (150 euros translated at the spot rate on December 31, year 1, of €1 = $1.10). Because Branch was formed in year 1, its owner functional currency net value on the last day of the preceding taxable year is zero. *See* §1.987-4(d)(1)(iii). Therefore, the change in owner functional currency net value is an increase of $165.

(*2*) *Residual increase to net assets for year 1*. Under §1.987-4(d)(10), unrecognized section 987 gain or loss for a taxable year is decreased by any residual increase to net assets (and increased by any residual decrease to net assets), translated into the owner's functional currency at the yearly average exchange rate for the taxable year. For this purpose, the residual increase (or decrease) to net assets is equal to the change in net value of the section 987 QBU, determined in the section 987 QBU's functional currency (that is, the QBU net value). *See* §1.987-4(d)(10)(ii)(B) and (e)(2)(ii). On December 31, year 1, Branch held land with a basis of €100 euros and €50 cash. Therefore, on the last day of year 1, Branch has a QBU net value of €150. Because Branch was formed in year 1, its QBU net value on the last day of the preceding taxable year is zero. *See* §1.987-4(d)(1)(iii). Therefore, the residual increase to net assets is €150. This results in a negative adjustment to annual unrecognized section 987 gain or loss of $157.50 for year 1 (equal to €150 translated at the yearly average exchange rate for year 1 of €1 = $1.05).

(D) *Annual unrecognized section 987 gain or loss for year 2*. As explained in paragraphs (l)(4)(ii)(D)(*1*) and (*2*) of this section (*Example 4*), in year 2, the change in owner functional currency net value under §1.987-4(d)(1) is an increase of $45, and there is a negative adjustment of $28.75 under §1.987-4(d)(10). Therefore, DC's annual unrecognized section 987 gain for year 2 is $16.25.

(*1*) *Change in owner functional currency net value for year 2*. On December 31, year 2, Branch held land with a basis of €100 and €75 cash. Therefore, on the last day of year 2, Branch's owner functional currency net value is $210 (175 euros translated at the spot rate on December 31, year 2, of €1 = $1.20). As explained in paragraph (l)(4)(ii)(C)(*1*) of this section (*Example 4*), Branch's owner functional currency net value on the last day of year 1 was $165. Therefore, the change in owner functional currency net value is an increase of $45.

(*2*) *Residual increase to net assets for year 2*. On December 31, year 2, Branch held land with a basis of €100 and €75 cash. Therefore, on the last day of year 2, Branch has a QBU net value of €175. As explained in paragraph (l)(4)(ii)(C)(*2*) of this section (*Example 4*), Branch had a QBU net value of €150 on December 31, year 1. Therefore, the residual increase to net assets is €25. This results in a negative adjustment to annual unrecognized section 987 gain or loss of $28.75 for year 2 (equal to a reduction of €25, translated at the yearly average exchange rate for year 2 of €1 = $1.15).

(E) *Annual unrecognized section 987 gain or loss for year 3*. As explained in paragraphs (l)(4)(ii)(E)(*1*) and (*2*) of this section (*Example 4*), in year 3, the change in owner functional currency net value under §1.987-4(d)(1) is a decrease of $70, and there is a positive adjustment of $93.75 under §1.987-4(d)(10). Therefore, DC's annual unrecognized section 987 gain for year 3 is $23.75.

(*1*) *Change in owner functional currency net value for year 3*. On December 31, year 3, Branch held land with a basis of €100. Therefore, on the last day of year 3, Branch's owner functional currency net value is $140 (100 euros translated at the spot rate on December 31, year 3, of €1 = $1.40). As explained in paragraph (l)(4)(ii)(D)(*1*) of this section (*Example 4*), Branch's owner functional currency net value on the last day of year 2 was $210. Therefore, the change in owner functional currency net value is a decrease of $70.

(*2*) *Residual decrease to net assets for year 3*. On December 31, year 3, Branch held land with a basis of €100. Therefore, on the last day of year 3, Branch has a QBU net value of €100. As explained in paragraph (l)(4)(ii)(D)(*2*) of this section (*Example 4*), Branch had a QBU net value of €175 on December 31, year 2. Therefore, the residual decrease to net assets is €75. This results in a positive adjustment to annual unrecognized section 987 gain or loss of $93.75 for year 3 (equal to €75, translated at the yearly average exchange rate for year 3 of €1 = $1.25).

(F) *Determination of unrecognized section 987 gain or loss in year 4*. For purposes of determining unrecognized section 987 gain or loss in year 4 under §1.987-4(d), the owner functional currency net value of Branch on the last day of year 3 is determined by translating the €100 basis of the land at the spot rate on December 31, year 3 (€1 = $1.40). Therefore, the owner functional currency net value of Branch on the last day of year 3 is $140.

(5) *Example 5: Error in application of method*—(i) *Facts*. The facts are the same as described in paragraph (l)(1)(i) of this section (*Example 1*), except that DC inadvertently miscalculated the amount of the June 30, year 3, remittance as being €90 rather than €100. This reduced the amount of section 987 gain recognized by DC in year 3.

(ii) *Analysis*. DC committed an error in its application of the earnings and capital method to Branch. Under paragraph (e)(4)(iv)(A) of this section, DC is nonetheless treated as having applied an eligible pretransition method. However, under paragraph (e)(4)(iv)(B) of this section, DC must determine its pretransition gain or loss as though the error had not been made. Therefore, DC computes its pretransition gain or loss as described in paragraph (l)(1)(ii)(B) of this section (*Example 1*). DC has $35 of pretransition gain with respect to Branch.

(6) *Example 6: Consistent practice not treated as an error*—(i) *Facts*. Before the transition date, DC used the earnings and capital method described

in the 1991 proposed regulations under section 987 with respect to Branch, as described in paragraph (l)(1)(i) of this section (*Example 1*). In years 1, 2, and 3, Branch made recurring purchases of inventory from Owner, which Branch sold to unrelated customers. In connection with the purchase transactions, Branch transferred cash to Owner, and Owner transferred inventory to Branch. Owner did not take these transfers into account in determining the amount of any remittance and, accordingly, did not recognize section 987 gain or loss with respect to these transfers. However, Owner consistently adjusted Branch's equity and basis pools in a reasonable manner to reflect all transfers between Owner and Branch; for this purpose, the amount of each transfer made in connection with the purchase transactions was translated using the average rate for the relevant taxable year. Owner also adjusted Branch's equity and basis pools to account for Branch's income from the sale of inventory.

(ii) *Analysis*—(A) *DC's method is an eligible pretransition method*. Before the transition date, DC followed the earnings and capital method described in the 1991 proposed regulations under section 987 with respect to Branch. This method is an eligible pretransition method under paragraph (e)(4)(i) of this section. Therefore, DC determines its pretransition gain or loss with respect to Branch under paragraph (e)(2) of this section.

(B) *Effect of consistent practice*. Before the transition date, Owner engaged in a consistent practice under which Owner did not account for inventory purchase transactions in determining the amount of a remittance requiring the recognition of gain or loss under section 987(3). However, Owner consistently accounted for the disregarded transfers in a reasonable manner for purposes of computing its equity and basis pools. Under paragraph (e)(4)(v) of this section, this consistent practice is not treated as an error in the application of a pretransition method and does not preclude Owner's method from being treated as an eligible pretransition method. Therefore, Owner must take this consistent practice into account in determining pretransition gain or loss under paragraph (e)(2) of this section. In particular, Owner must use the equity and basis pools computed under its consistent practice (rather than the equity and basis pools it would have computed if it had historically taken the disregarded transfers into account in determining the amount of remittances) to determine the deemed termination amount under paragraph (e)(2)(i)(A) of this section.

§1.987-11 Suspended section 987 loss relating to certain elections; loss-to-the-extent-of-gain rule.

(a) *In general*. This section provides rules relating to suspended section 987 loss. Paragraph (b) of this section provides rules for computing the cumulative suspended section 987 loss with respect to a section 987 QBU or successor suspended loss QBU. Paragraph (c) of this section provides rules that suspend section 987 loss that would otherwise be recognized when a current rate election is in effect. Paragraph (d) of this section provides rules that treat net unrecognized section 987 loss and deferred section 987 loss as suspended section 987 loss when an annual recognition election is made or a current rate election is revoked. Paragraph (e) of this section describes the extent to which suspended section 987 loss is recognized under a loss-to-the-extent-of-gain rule. Paragraph (f) of this section provides rules for determining recognition groupings based on the source and character of section 987 gain or loss. Paragraph (g) of this section provides examples illustrating the rules of this section.

(b) *Cumulative suspended section 987 loss in a recognition grouping*—(1) *In general*. The cumulative suspended section 987 loss in a recognition grouping with respect to a section 987 QBU or a successor suspended loss QBU for the current taxable year is equal to the cumulative suspended section 987 loss in the recognition grouping for the prior taxable year, decreased by the amount of suspended section 987 loss in the recognition grouping that was recognized with respect to the QBU under paragraph (e) of this section or under §1.987-13(b) through (d) in the prior taxable year, and increased by the amount that becomes suspended section 987 loss in the recognition grouping with respect to the QBU in the current taxable year (including under §1.987-10(e)(5)(i)(B)(*1*)). If the taxable year is the first taxable year of the section 987 QBU (or the first taxable year in which the section 987 regulations apply), the cumulative suspended section 987 loss for the prior taxable year is zero. An owner's (or original suspended loss QBU owner's) total cumulative suspended section 987 loss in a recognition grouping is equal to the sum of its cumulative suspended section 987 gain or loss with respect to each section 987 QBU and successor suspended loss QBU.

(2) *Combined QBU*. For purposes of paragraph (b)(1) of this section, in the taxable year of a combination, the cumulative suspended section 987 loss in a recognition grouping with respect to a combined QBU for the prior taxable year is equal to the sum of the cumulative suspended section 987 loss in the recognition grouping with respect to each combining QBU for the prior taxable year; the suspended section 987 loss in a recognition grouping with respect to a combined QBU that was recognized in the prior taxable year is equal to sum of the suspended section 987 loss in the recognition grouping with respect to each combining QBU that was recognized in the prior taxable year.

(3) *Separated QBU*. For purposes of paragraph (b)(1) of this section, in the taxable year of a separation, the cumulative suspended section 987 loss in a recognition grouping with respect to a separated QBU for the prior taxable year is equal to the cumulative suspended section 987 loss in the recognition grouping with respect to the separating QBU for the prior taxable year multiplied by the separation fraction; the suspended section 987 loss in a recognition grouping with respect to a separated QBU that was recognized in the prior taxable year is equal to the suspended section 987 loss in the recognition grouping with respect to the separating QBU that was recognized in the prior taxable year multiplied by the separation fraction.

(c) *Suspension of section 987 loss for taxable years in which a current rate election is in effect and an annual recognition election is not in effect*—(1) *In general*. Except as provided in paragraph (c)(2) of this section, in a taxable year in which a current rate election is in effect and an annual recognition election is not in effect, to the extent that an owner's net unrecognized section 987 loss with respect to a section 987 QBU would otherwise be recognized under §1.987-5 (including pursuant to §1.987-12(b)), or its deferred section 987 loss would otherwise be recognized under §1.987-12(c), the net unrecognized section 987 loss or deferred section 987 loss is not recognized by the owner and instead becomes suspended section 987 loss. *See* paragraph (g)(1) of this section (*Example 1*) for an illustration of this rule.

(2) *De minimis rule*. Paragraph (c)(1) of this section does not apply in a taxable year of an owner in which the total amount of net unrecognized section 987 loss or deferred section 987 loss of the owner and all members of the owner's controlled group that would (but for the application of this paragraph (c)(2) and §1.987-7(d)(2)(iii)) become suspended section 987 loss under paragraph (c)(1) of this section

or §1.987-7(d) does not exceed the lesser of—

(i) $3 million; or

(ii) Two percent of the total amount of gross income of the owner and all members of the owner's controlled group for the taxable year.

(3) *Taxable year of controlled group members*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, for purposes of applying paragraph (c)(2) of this section with respect to an owner, suspended section 987 loss and gross income of a member of the owner's controlled group is determined by reference to the member's suspended section 987 loss and gross income for its taxable year ending with or within the owner's taxable year.

(ii) *Owner is a CFC*. For purposes of applying paragraph (c)(2) of this section with respect to an owner that is a CFC, suspended section 987 loss and gross income of a member of the owner's controlled group is determined by reference to the member's suspended section 987 loss and gross income for its taxable year ending with or within the owner's required year described in section 898(c)(1), without regard to section 898(c)(2).

(d) *Suspension of net unrecognized section 987 loss upon making or revoking certain elections*—(1) *Making an annual recognition election*. At the beginning of the first taxable year for which an annual recognition election is in effect, an owner's net accumulated unrecognized section 987 loss and deferred section 987 loss are converted into suspended section 987 loss if either—

(i) A current rate election was in effect for the immediately preceding taxable year; or

(ii) A current rate election was not in effect for the immediately preceding taxable year and, as of the beginning of the taxable year, the sum of the owner's net accumulated unrecognized section 987 loss and deferred section 987 loss exceeds the sum of the owner's net accumulated unrecognized section 987 gain and deferred section 987 gain by more than $5 million.

(2) *Revoking a current rate election*. At the beginning of the first taxable year in which a current rate election ceases to be in effect, an owner's net accumulated unrecognized section 987 loss and deferred section 987 loss are converted into suspended section 987 loss. *See* paragraph (g)(3) of this section (*Example 3*) for an illustration of this rule.

(e) *Loss-to-the-extent-of-gain rule*—(1) *In general*. An owner of a section 987 QBU (or an original suspended loss QBU owner) only recognizes suspended section 987 loss to the extent described in this paragraph (e) (the *loss-to-the-extent-of-gain rule*). *See* §1.987-13(b) through (d) for rules requiring the recognition of additional suspended section 987 loss (after the application of the loss-to-the-extent-of-gain rule) in connection with certain transactions.

(2) *Separate determination for each recognition grouping*. The amount of suspended section 987 loss recognized is determined separately for the suspended section 987 loss in each recognition grouping. Because the recognition groupings generally are determined on the basis of the initial assignment of section 987 gain or loss under §1.987-6(b)(2)(i), the loss-to-the-extent-of-gain rule generally is applied on the basis of the initial assignment of section 987 gain or loss.

(3) *Amount of suspended section 987 loss recognized*. Except as provided in paragraph (e)(5) or (6) of this section, the amount of suspended section 987 loss in each recognition grouping that an owner recognizes in a taxable year is equal to the sum (if positive) of the current year gain amount described in paragraph (e)(3)(i) of this section and the lookback gain amount described in paragraph (e)(3)(ii) of this section, but may not exceed the owner's total cumulative suspended section 987 loss in the recognition grouping. If the sum of the current year gain amount and the lookback gain amount is negative, then the amount of suspended section 987 loss recognized under this paragraph (e) is zero. *See* paragraphs (g)(1) and (2) of this section (*Examples 1* and *2*) for an illustration of this rule.

(i) *Current year gain amount*. The current year gain amount described in this paragraph (e)(3)(i) is equal to the section 987 gain in the recognition grouping that is recognized by the owner in the taxable year, reduced (including below zero) by section 987 loss (other than suspended section 987 loss) in the recognition grouping that is recognized by the owner in the taxable year.

(ii) *Lookback gain amount*. The lookback gain amount described in this paragraph (e)(3)(ii) is equal to the section 987 gain in the recognition grouping that was recognized by the owner in the lookback period, reduced (including below zero) by section 987 loss (other than suspended section 987 loss described in paragraph (e)(3)(iii) of this section) in the recognition grouping that was recognized by the owner in the lookback period. The total amount of suspended section 987 loss recognized by reason of the recognition of an amount of section 987 gain cannot, in any event, exceed the amount of section 987 gain recognized.

(iii) *Suspended section 987 loss not taken into account*—(A) *In general*. For purposes of applying paragraph (e)(3)(ii) of this section in a taxable year (the *current taxable year*), suspended section 987 loss recognized during the lookback period is not taken into account if it was recognized under this paragraph (e) by reason of the recognition of section 987 gain that was recognized before the lookback period for the current taxable year.

(B) *Ordering rule*. For purposes of this paragraph (e)(3)(iii), suspended section 987 loss is treated as recognized by reason of the most recently recognized section 987 gain in the same recognition grouping. *See* paragraph (g)(2) of this section (*Example 2*) for an illustration of this rule.

(iv) *Lookback period*—(A) *In general*. Except as provided in paragraph (e)(3)(iv)(B) of this section, the lookback period with respect to a taxable year of an owner means the three preceding taxable years of the owner (or, if the owner was not in existence for three preceding taxable years, each taxable year in which the owner existed), but it does not include any taxable year beginning before the transition date described in §1.987-10(c)(1).

(B) *Taxable years in which both a current rate election and an annual recognition election are in effect.* In a taxable year of an owner in which both a current rate election and an annual recognition election are in effect, the lookback period includes all prior taxable years of the owner in which both a current rate election and an annual recognition election were continuously in effect.

(v) *Anti-abuse rule*. If an owner recognizes section 987 gain with a principal purpose of reducing the Federal income tax liability of the owner (or its U.S. shareholders or partners, as applicable), including over multiple taxable years, the section 987 gain is disregarded for purposes of this paragraph (e)(3). For example, this paragraph (e)(3)(v) may apply if an owner that is a CFC recognizes section 987 gain that is offset by a tax attribute of one of the CFC's U.S. shareholders that would not otherwise be used (such as excess foreign tax credits with respect to section 951A category income, or a tested loss). In determining whether a principal purpose described in this paragraph (e)(3)(v) exists, all relevant facts and circumstances are considered, including the extent to which the transaction giving rise to the recognition of section 987 gain resulted in a sustained economic contraction of the section 987 QBU over a period of at least twelve months.

(4) *Suspended section 987 loss recognized with respect to each section 987 QBU and suspended section 987 loss QBU*. The amount of suspended section 987 loss in a recognition grouping that is recognized by an owner in a taxable year is treated as attributable to each section 987 QBU or successor suspended loss QBU in proportion to the QBU's suspended section 987 loss in that recognition grouping.

(5) S*ection 381(a) transactions*—(i) *In general*. Except as provided in paragraph (e)(5)(ii) of this section (or to the extent that other limitations apply), if one corporation (acquiring corporation) acquires the assets of another corporation (transferor corporation) in a transaction described in section 381(a), section 987 gain or loss recognized by the transferor corporation during the lookback period is taken into account in determining the lookback gain amount of the acquiring corporation in taxable years ending after the transaction under paragraph (e)(3)(ii) of this section. If the lookback period for a taxable year of the acquiring corporation is determined under paragraph (e)(3)(iv)(A) of this section, the lookback period includes each taxable year of the transferor corporation ending with or within the current taxable year of the acquiring corporation or during the acquiring corporation's lookback period. If the lookback period for a taxable year of the acquiring corporation is determined under paragraph (e)(3)(iv)(B) of this section, the lookback period includes only taxable years of the transferor corporation in which both an annual recognition election and a current rate election were continuously in effect before the transaction (and only if both elections were continuously in effect from the date of the transaction through the current taxable year).

(ii) *Limitation for inbound nonrecognition transactions*. If a foreign corporation ceases to exist in a transaction described in §1.987-8(c)(1)(ii) (inbound section 332 liquidation) or §1.987-8(c)(2)(ii) (inbound reorganization), section 987 gain recognized by the foreign corporation before the transaction is disregarded for purposes of applying paragraph (e)(3) of this section in taxable years ending after the transaction.

(6) *Consolidated group members*—(i) *In general*. All members of a consolidated group are treated as a single owner for purposes of applying this paragraph (e).

(ii) *Suspended section 987 losses arising in separate return limitation years*. This paragraph (e)(6)(ii) applies to suspended section 987 losses arising in a separate return limitation year (SRLY, as defined in §1.1502-1(f)) or treated as arising in a SRLY under the principles of §1.1502-21(c) (*SRLY section 987 losses*). The aggregate of a member's SRLY section 987 losses that are included in the determination of consolidated taxable income for all consolidated return years of the group may not exceed the aggregate consolidated net income for all consolidated return years of the group determined by reference to only the member's items of section 987 gain or loss, including the member's section 987 losses actually absorbed by the group in the taxable year (whether or not absorbed by the member). For purposes of applying this paragraph (e)(6)(ii), the principles of §1.1502-21(c) (including the SRLY subgroup principles of §1.1502-21(c)(2)) apply with appropriate adjustments.

(f) *Recognition groupings*. The term *recognition grouping* means the section 987 gain or loss (including section 987 gain or loss that is recognized under §1.987-5, deferred section 987 gain or loss, suspended section 987 loss, or pretransition gain or loss that is recognized under §1.987-10(e)(5)(ii)) described in paragraph (f)(1) or (2) of this section, as applicable. If an owner has suspended section 987 loss with respect to a terminating QBU in a taxable year ending before the transition date described in §1.987-10(c)(1), section 987 gain or loss of the owner (other than section 987 gain or loss with respect to the terminating QBU) is assigned to a recognition grouping based on the method that is used to determine the source and character of section 987 gain or loss for that taxable year.

(1) *Sourcing and section 904 category*. Except as provided in paragraph (f)(2) of this section, a recognition grouping includes only section 987 gain or loss that is initially assigned to one of the following statutory and residual groupings—

(i) U.S. source income; or

(ii) Foreign source income in a single section 904 category.

(2) *Statutory and residual groupings for CFC owners*. In the case of an owner that is a controlled foreign corporation, a recognition grouping includes only section 987 gain or loss that is initially assigned to one of the statutory and residual groupings described in paragraph (f)(1) of this section and that is also initially assigned to one of the following statutory and residual groupings—

(i) Tentative tested income;

(ii) Each separate subpart F income group (as defined in §1.960-1(d)(2)(ii)(B));

(iii) Income described in section 952(b) (ECI that is excluded from subpart F income); or

(iv) Income not described in paragraphs (f)(2)(i) through (iii) of this section.

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

(1) *Example 1: Suspension of section 987 loss and recognition of suspended section 987 loss*—(i) *Facts*. CFC is a controlled foreign corporation that has the U.S. dollar as its functional currency. CFC owns three section 987 QBUs, QBU1, QBU2, and QBU3. QBU1 has the euro as its functional currency, QBU2 has the pound as its functional currency, and QBU3 has the yen as its functional currency. CFC is subject to a current rate election but not an annual recognition election. CFC is also subject to an election under §1.987-6(b)(2)(i)(C) (treating section 987 gain or loss relating to passive foreign personal holding company income as attributable to section 988 transactions). An election has not been made under §1.951A-2(c)(7)(viii) (GILTI high-tax exclusion) with respect to CFC. In year 1, CFC did not have

cumulative suspended section 987 loss with respect to any of its QBUs and did not have outstanding deferred section 987 gain or loss. In the three years before year 2, CFC did not recognize any section 987 gain or loss. In year 2, CFC has net unrecognized section 987 loss of $200 with respect to QBU1, net unrecognized section 987 loss of $1,000 with respect to QBU2, and net unrecognized section 987 gain of $1,000 with respect to QBU3. In year 2, each QBU makes a remittance, and CFC's remittance proportion (determined under §1.987-5(b)(1)) is 25% with respect to QBU1, 15% with respect to QBU2, and 10% with respect to QBU3. For purposes of §1.987-6(b)(2)(i), all of QBU1's assets generate foreign source passive category income that corresponds to one or more subpart F income groups described in §1.960-1(d)(2)(ii)(B)(*2*)(*i*) through (*v*), and all of QBU2's and QBU3's assets generate foreign source general category tested income. Another member of CFC's controlled group owns a section 987 QBU with respect to which $10 million of net unrecognized section 987 loss becomes suspended section 987 loss under paragraph (c)(1) of this section in year 2.

(ii) *Analysis*—(A) *Application of §§1.987-5 and 1.987-6 and paragraph (c) of this section*. In year 2, CFC recognizes $100 of section 987 gain with respect to QBU3 (10% of $1,000) under §1.987-5(a). Under §1.987-6(b)(2)(i)(A), (B), and (D), the section 987 gain is initially characterized as foreign source general category tentative tested income. If a current rate election was not in effect, in year 2 CFC would recognize $50 of section 987 loss with respect to QBU1 (25% of $200) and $150 of section 987 loss with respect to QBU2 (15% of $1,000). However, under paragraph (c) of this section, these amounts instead become suspended section 987 loss. The de minimis rule under paragraph (c)(2) of this section does not apply because a member of CFC's controlled group has more than $3 million of section 987 loss that is suspended in year 2 under paragraph (c)(1) of this section. Under §1.987-6(b)(2)(i)(A) and (B), the $50 of suspended section 987 loss with respect to QBU1 is initially characterized as foreign source passive category income assigned to a subpart F income group described in §1.960-1(d)(2)(ii)(B)(*2*)(*i*) through (*v*), and is treated as foreign currency loss of the CFC attributable to section 988 transactions not directly related to the business needs of the CFC because an election under §1.987-6(b)(2)(i)(C) is in effect. Under §1.987-6(b)(2)(i)(A), (B), and (D), the $150 of suspended section 987 loss with respect to QBU2 is initially characterized as foreign source general category tentative tested income.

(B) *Cumulative suspended section 987 loss*. Under paragraph (b) of this section, in year 2, CFC's cumulative suspended section 987 loss in the recognition grouping of foreign source passive category income in a separate subpart F income group for foreign currency gains of CFC with respect to QBU1 is $50, the amount that became suspended section 987 loss in the recognition grouping in year 2. In addition, CFC's total cumulative suspended section 987 loss in that recognition grouping is $50. Similarly, CFC's cumulative suspended section 987 loss in the recognition grouping of foreign source general category tentative tested income with respect to QBU2 is $150, the amount that became suspended section 987 loss in the recognition grouping in year 2. In addition, CFC's total cumulative suspended section 987 loss in that recognition grouping is $150.

(C) *Current year gain amount and lookback gain amount*. Under paragraph (e)(3) of this section, in year 2, CFC recognizes suspended section 987 loss in a recognition grouping to the extent of the sum of the current year gain amount described in paragraph (e)(3)(i) of this section and the lookback gain amount described in paragraph (e)(3)(ii) of this section. In the recognition grouping of foreign source general category tentative tested income, the current year gain amount described in paragraph (e)(3)(i) of this section is equal to the section 987 gain of $100 recognized by CFC in year 2 with respect to QBU3. The current year gain amount for all other recognition groupings is zero. During the lookback period (the three years before year 2), CFC did not recognize any section 987 gain or loss. Therefore, the lookback gain amount described in paragraph (e)(3)(ii) of this section is zero for all recognition groupings.

(D) *Recognition of suspended section 987 loss*. In year 2, CFC has $50 of total cumulative suspended section 987 loss in the recognition grouping of foreign source passive category income in a separate subpart F income group for foreign currency gains of CFC and $150 of total cumulative suspended section 987 loss in the recognition grouping of foreign source general category tentative tested income. In the recognition grouping of foreign source general category tentative tested income, CFC has a current year gain amount of $100 and a lookback gain amount of zero ($100 in total). Therefore, CFC recognizes $100 of suspended section 987 loss in that recognition grouping. Under paragraph (e)(4) of this section, the cumulative suspended section 987 loss that is recognized by CFC is attributable to QBU2, because QBU2 is CFC's only QBU with cumulative suspended section 987 loss in the recognition grouping of foreign source general category tentative tested income. Because no election under §1.951A-2(c)(7) applies in year 2, both the $100 of recognized section 987 gain and the $100 of recognized section 987 loss are allocated to foreign source general category tested income. *See* §1.987-6(b)(2)(ii). The amounts of suspended section 987 loss not recognized (that is, $50 of suspended section 987 loss assigned to foreign source passive category income in the subpart F income group for foreign currency gains of CFC with respect to QBU1 and $50 of suspended section 987 loss assigned to foreign source general category tentative tested income with respect to QBU2) remain suspended.

(2) *Example 2: Recognition of suspended section 987 loss by reason of gain recognized during the lookback period*—(i) *Facts*. CFC is a controlled foreign corporation that has the U.S. dollar as its functional currency. CFC owns QBU1, a section 987 QBU with the euro as its functional currency, and CFC has no other QBUs. Assume that all section 987 gain or loss (including suspended section 987 loss) is assigned to the same recognition grouping. CFC is subject to a current rate election but not an annual recognition election. Before year 1, QBU1 does not have cumulative suspended section 987 loss. In year 1, CFC recognizes section 987 gain of $10 million with respect to QBU1. In year 3, CFC recognizes section 987 gain of $15 million with respect to QBU1. In year 4, QBU1 has net unrecognized section 987 loss, and $10 million of the net unrecognized section 987 loss becomes suspended section 987 loss under paragraph (c) of this section. In year 6, an additional $10 million of net unrecognized section 987 loss with respect to QBU1 becomes suspended section 987 loss under paragraph (c) of this section.

(ii) *Analysis*—(A) *Recognition of suspended section 987 loss in year 4*. In year 4, CFC's total cumulative suspended section 987 loss is $10 million (that is, the loss that becomes suspended in year 4). The current year gain amount under paragraph (e)(3)(i) of this section is zero, because CFC does not recognize section 987 gain in year 4. The lookback period under paragraph (e)(3)(iv)(A) of this section is three years (years 1 through 3). The lookback gain amount under paragraph (e)(3)(ii) of this section is $25 million (the sum of the $10 million of section 987 gain recognized in year 1 and the $15 million of section 987 gain recognized in year 3). Therefore, under paragraph (e)(3) of this section, CFC recognizes suspended section 987 loss of $10 million. Under paragraph (e)(3)(iii)(B) of this section, the suspended section 987 loss is considered to be recognized by reason of the section 987 gain recognized in year 3, which is the most recent taxable year in which section 987 gain was recognized.

(B) *Recognition of suspended section 987 loss in year 6*. In year 6, CFC's total cumulative suspended section 987 loss is $10 million (that is, the loss that becomes suspended in year 6). The current year gain amount under paragraph (e)(3)(i) of this section is zero, because CFC does not recognize section 987 gain in year 6. The lookback period under paragraph (e)(3)(iv)(A) of this section is three years (years 3 through 5). The lookback gain amount under paragraph (e)(3)(ii) of this section is $5 million (the sum of the section 987 gain of $15 million recognized in year 3 and the suspended section 987 loss of $10 million recognized in year 4 by reason of the section 987 gain recognized in year 3). Therefore, under paragraph (e)(3) of this section, CFC recognizes $5 million of suspended section 987 loss in year 6.

(iii) *Alternative facts*. Assume the facts are the same as described in paragraph (g)(2)(i) of this section, with the following modifications. In year 1, CFC recognizes section 987 gain of $10 million with respect to QBU1. CFC does not recognize section 987 gain in year 3. In year 4, $10 million of net unrecognized section 987 loss with respect to QBU1 becomes suspended section 987 loss under paragraph (c) of this section. In year 5, CFC recognizes section 987 gain of $15 million with respect to QBU1. In year 6, $10 million of net unrecognized section 987 loss with respect to QBU1 becomes suspended section 987 loss under paragraph (c) of this section.

(iv) *Analysis of alternative facts*—(A) *Recognition of suspended section 987 loss in year 4*. In year 4, CFC's total cumulative suspended section 987 loss is $10 million (that is, the loss that becomes suspended in year 4). The current year gain amount under paragraph (e)(3)(i) of this section is zero, because CFC does not recognize section 987 gain in year 4. The lookback period under paragraph (e)(3)(iv)(A) of this section is three years (years 1 through 3). The lookback gain amount under paragraph (e)(3)(ii) of this section is $10 million (equal to the $10 million of section 987 gain recognized in year 1). Therefore, under paragraph (e)(3) of this section, CFC recognizes suspended section 987 loss of $10 million in year 4. Under paragraph (e)(3)(iii)(B) of this section, the suspended section 987 loss is considered to be recognized by reason of the section 987 gain recognized in year 1, which is the most recent taxable year in which section 987 gain was recognized.

(B) *Recognition of suspended section 987 loss in year 6*. In year 6, CFC's total cumulative suspended section 987 loss is $10 million (that is, the loss that becomes suspended in year 6). The current year gain amount under paragraph (e)(3)(i) of this section is zero because CFC does not recognize section 987 gain in year 6. The lookback period under paragraph (e)(3)(iv)(A) of this section is three years (years 3 through 5). The lookback gain amount under paragraph (e)(3)(ii) of this section is $15 million (equal to the section 987 gain of $15 million recognized in year 5). Under paragraph (e)(3)(iii)(A) of this section, the suspended section 987 loss recognized in year 4 is not taken into account in determining the lookback gain amount, because it was recognized by reason of the section 987 gain recognized in year 1 (before the beginning of the lookback period for year 6). Therefore, under paragraph (e)(3) of this section, CFC recognizes $10 million of suspended section 987 loss in year 6.

(3) *Example 3: Suspension of section 987 loss when a current rate election is revoked*—(i) *Facts*. U.S. Corp is a domestic corporation that owns all of the interests in DE1. DE1 owns Business A, which is a section 987 QBU of U.S. Corp. In year 1, U.S. Corp made a current rate election but not an annual recognition election. In year 9, U.S. Corp has net unrecognized section 987 loss of $2 million with respect to Business A, which is not recognized or suspended in year 9. U.S. Corp revokes its current rate election effective for year 10. In year 10, before the application of this section, U.S. Corp has net accumulated unrecognized section 987 loss of $2 million.

(ii) *Analysis*. Under paragraph (d)(2) of this section, U.S. Corp's net accumulated unrecognized section 987 loss of $2 million with respect to Business A is converted into suspended section 987 loss at the beginning of year 10, the first taxable year in which the current rate election ceases to be in effect.

§1.987-12 Deferral of section 987 gain or loss.

(a) *Overview*—(1) *Scope*. This section provides rules that defer the recognition of section 987 gain or loss and rules for recognizing (or suspending) deferred section 987 gain or loss. This paragraph (a) provides an overview of this section and certain instances when this section does not apply. Paragraph (b) of this section describes the extent to which net unrecognized section 987 gain or loss is recognized under §1.987-5 (or in certain cases, suspended) or becomes deferred section 987 gain or loss in connection with a deferral event. Paragraph (c) of this section describes the extent to which deferred section 987 gain or loss is recognized (or in certain cases, suspended) upon the occurrence of subsequent events. Paragraph (d) of this section provides a rule relating to the treatment of a successor deferral QBU when deferred section 987 loss becomes suspended section 987 loss. Paragraph (e) of this section provides an anti-abuse rule. Paragraph (f) of this section provides rules for determining the deferred section 987 gain or loss of combined and separated QBUs. Paragraph (g) of this section provides definitions. Paragraph (h) of this section provides examples illustrating the rules of this section.

(2) *Exceptions*—(i) *Annual recognition election*. This section does not apply to a termination of a section 987 QBU in a taxable year in which an annual recognition election is in effect.

(ii) *De minimis rule*. This section does not apply in a taxable year if the aggregate amount of net unrecognized section 987 gain or loss of the owner with respect to all of its section 987 QBUs that would become deferred section 987 gain or loss under this section does not exceed $5 million.

(b) *Treatment of section 987 gain and loss in connection with a deferral event*. Notwithstanding §1.987-5 (general rule requiring recognition of section 987 gain or loss in the taxable year of a remittance), the owner of a section 987 QBU with respect to which a deferral event occurs (an *original deferral QBU*) includes in taxable income section 987 gain or loss in connection with the deferral event only to the extent provided in this paragraph (b).

(1) *Gain or loss recognized (or suspended) in the taxable year of a deferral event*. In the taxable year of a deferral event with respect to an original deferral QBU, the owner of the original deferral QBU recognizes section 987 gain or loss under §1.987-5, except that, solely for purposes of applying §1.987-5, all assets and liabilities of the original deferral QBU that, immediately after the deferral event, are reflected on the books and records of a successor deferral QBU are treated as not having been transferred and therefore as remaining on the books and records of the original deferral QBU notwithstanding the deferral event. Notwithstanding the prior sentence, any section 987 loss that would otherwise be recognized under this paragraph (b)(1) and §1.987-5 may instead become suspended loss under §1.987-11(c) if a current rate election is in effect, or under §1.987-13(h) if the deferral event also constitutes an outbound loss event.

(2) *Deferred section 987 gain or loss*—(i) *In general*. In the taxable year of a deferral event with respect to an original deferral QBU, any net unrecognized section 987 gain or loss that is not recognized or suspended in the taxable year of the deferral event becomes deferred section 987 gain or loss of the original deferral QBU owner. Suspended section 987 loss does not become deferred section 987 loss under this paragraph (b)(2).

(ii) *Deferred section 987 gain or loss attributable to a successor deferral QBU*. A portion of the deferred section 987 gain or loss described in paragraph (b)(2)(i) of this section becomes deferred section 987 gain or loss with respect to each successor deferral QBU. Such portion is equal to the deferred section 987 gain or loss multiplied by a fraction, the numerator of which is the aggregate adjusted basis of the gross assets transferred to the successor deferral QBU in connection with the deferral event and the denominator of which is the aggregate adjusted basis of the gross assets transferred to all successor deferral QBUs in connection with the deferral event.

(c) *Recognition (or suspension) of deferred section 987 gain or loss following a deferral event*. An original deferral QBU owner recognizes deferred section 987 gain or loss with respect to a successor deferral QBU in the taxable year of the deferral event and in subsequent taxable years as provided in this paragraph (c).

(1) *Recognition upon a subsequent remittance*—(i) *In general*. Except as provided in paragraph (c)(2) of this section, an original deferral QBU owner recognizes deferred section 987 gain or loss in the taxable year of the deferral event, and in subsequent taxable years, upon a remittance from a successor deferral QBU to the owner of the successor deferral QBU (*successor deferral QBU owner*) in the amount described in paragraph (c)(1)(ii) of this section. Notwithstanding the prior sentence, any deferred section 987 loss that would otherwise be recognized under this paragraph (c)(1) may instead become suspended section 987 loss under §1.987-

11(c) (if a current rate election is in effect with respect to the original deferral QBU owner) or under §1.987-7(d)(1)(ii) (in the case of a partnership).

(ii) *Amount*. The amount of deferred section 987 gain or loss that is recognized (or suspended) pursuant to this paragraph (c)(1) in a taxable year of the original deferral QBU owner is the original deferral QBU owner's outstanding deferred section 987 gain or loss (that is, the amount of deferred section 987 gain or loss not previously recognized or suspended) with respect to the successor deferral QBU multiplied by the remittance proportion of the successor deferral QBU owner with respect to the successor deferral QBU for the taxable year ending with or within the taxable year of the original deferral QBU owner, as determined under §1.987-5(b) without regard to any annual recognition election of the successor deferral QBU owner. *See* paragraph (h)(4) of this section (*Example 4*) for an illustration of this rule.

(iii) *Deemed remittance by a successor deferral QBU*. For purposes of this paragraph (c)(1), in a taxable year of the original deferral QBU owner in which a successor deferral QBU ceases to be owned by a member of the controlled group that includes the original deferral QBU owner, the successor deferral QBU is treated as having a remittance proportion of one. Accordingly, if a successor deferral QBU ceases to be owned by a member of the controlled group that includes the original deferral QBU owner, the original deferral QBU owner's outstanding deferred section 987 gain or loss with respect to that successor deferral QBU will be recognized (or suspended). For purposes of this paragraph (c)(1), if the original deferral QBU owner goes out of existence and there is no qualified successor, in the last taxable year of the original deferral QBU owner, each successor deferral QBU is treated as having a remittance proportion of one. This paragraph (c)(1)(iii) does not affect the application of the section 987 regulations to the successor deferral QBU owner with respect to its ownership of the successor deferral QBU.

(2) *Deferral events and outbound loss events with respect to a successor deferral QBU*. Notwithstanding paragraph (c)(1) of this section, if assets of the successor deferral QBU (*transferred assets*) are transferred (or deemed transferred) in a transaction that would constitute a deferral event or an outbound loss event if the original deferral QBU owner owned the successor deferral QBU directly and the original deferral QBU owner had net unrecognized section 987 gain or loss with respect to the successor deferral QBU equal to its outstanding deferred section 987 gain or loss with respect to the successor deferral QBU (the *deemed transaction*), then, in accordance with the rules of this section and §1.987-13(h)—

(i) The original deferral QBU owner recognizes its outstanding deferred section 987 gain or loss, or suspends its outstanding deferred section 987 loss, to the extent it would have recognized or suspended net unrecognized section 987 gain or loss as a result of the deemed transaction; and

(ii) Each section 987 QBU is a successor deferral QBU to the extent it would have been after the deemed transaction and the original deferral QBU owner has deferred section 987 gain or loss with respect to the successor deferral QBU to the extent it would have after the deemed transaction;

(iii) Each eligible QBU is a successor suspended loss QBU to the extent it would have been after the deemed transaction and the original deferral QBU owner has suspended section 987 loss with respect to the suspended loss QBU to the extent it would have after the deemed transaction.

(d) *Successor deferral QBU becomes a successor suspended loss QBU*. A successor deferral QBU becomes a successor suspended loss QBU, and an original deferral QBU owner becomes an original suspended loss QBU owner, if any of the original deferral QBU owner's deferred section 987 loss with respect to the successor deferral QBU becomes suspended section 987 loss. An eligible QBU may be both a successor deferral QBU and a successor suspended loss QBU and the original deferral QBU owner may also be an original suspended loss QBU owner.

(e) *Anti-abuse rule*. No section 987 loss is recognized under this section, §1.987-5 or §1.987-13 in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(f) *Combinations and separations of successor deferral QBUs*. A combined QBU is a successor deferral QBU if either combining QBU was a successor deferral QBU. A separated QBU is a successor deferral QBU if the separating QBU was a successor deferral QBU.

(1) *Combined QBU*. The outstanding deferred section 987 gain or loss of a combined QBU in each recognition grouping for a taxable year is equal to the sum of the combining QBUs' outstanding deferred section 987 gain or loss in that recognition grouping.

(2) *Separated QBU*. The outstanding deferred section 987 gain or loss of a separated QBU in each recognition grouping for a taxable year is equal to the separating QBU's outstanding deferred section 987 gain or loss in each recognition grouping multiplied by the separation fraction.

(g) *Definitions*. The following definitions apply for purposes of this section.

(1) *Deferral event*. A deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy the conditions described in both paragraphs (g)(1)(i) and (ii) of this section.

(i) *Events*. The transaction or series of transactions constitutes:

(A) A termination of the section 987 QBU under §1.987-8(b)(2) (substantially all the assets transferred to the owner), §1.987-8(b)(5) (section 987 QBU ceases to be a section 987 QBU), or §1.987-8(b)(6) (individual or corporation ceases to be a direct owner of a section 987 QBU); or

(B) [Reserved]

(ii) *Assets on books of successor deferral QBU*. Immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor deferral QBU.

(2) *Successor deferral QBU*. A section 987 QBU (*potential successor deferral QBU*) is a successor deferral QBU with respect to a section 987 QBU referred to in paragraph (g)(1)(i) of this section if, immediately after the transaction or series of transactions described in that paragraph, the potential successor deferral QBU satisfies all of the conditions described in paragraphs (g)(2)(i) through (iii) of this section.

(i) The books and records of the potential successor deferral QBU reflect assets that, immediately before the transaction or series of transactions described in paragraph (g)(1)(i) of this section, were reflected on the books and records of the section 987 QBU referred to in paragraph (g)(1)(i) of this section.

(ii) The owner of the potential successor deferral QBU and the owner of the section 987 QBU referred to in paragraph (g)(1)(i) of this section immediately before the transaction or series of transactions described in paragraph (g)(1)(i) of this section are members of the same controlled group.

(iii) If the owner of the section 987 QBU referred to in paragraph (g)(1)(i) of this section immediately before the transaction or series of transactions described in paragraph (g)(1)(i) of this section was a U.S. person, the potential successor deferral QBU is owned by a U.S. person.

(3) *Original deferral QBU owner*. An original deferral QBU owner means, with respect to an original deferral QBU, the owner of the original deferral QBU immediately before the deferral event, or the owner's qualified successor.

(4) *Qualified successor*. A qualified successor with respect to a corporation (*transferor corporation*) means another corporation that acquires the assets of the transferor corporation in a transaction described in section 381(a) (*acquiring corporation*), provided that the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or the acquiring corporation is a controlled foreign corporation and the transferor corporation was a controlled foreign corporation. A qualified successor of a person includes the qualified successor of a qualified successor.

(h) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the stock of DC2, which is also a domestic corporation, and CFC1, a controlled foreign corporation. In addition, DC1, DC2, and CFC1 are members of a controlled group, and the de minimis rule of paragraph (a)(2)(ii) of this section is not applicable. Finally, except as otherwise provided, Business A is a section 987 QBU with the euro as its functional currency, there are no transfers between Business A and its owner, and Business A's assets are not depreciable or amortizable.

(1) *Example 1: Contribution of a section 987 QBU with net unrecognized section 987 gain to a member of the controlled group*—(i) *Facts*. DC1 owns Business A. The adjusted balance sheet of Business A reflects assets with an aggregate adjusted basis of €1,000x and no liabilities. DC1 contributes €900x of Business A's assets to DC2 in exchange for DC2 stock in a transaction to which section 351 applies. Immediately after the contribution, the remaining €100x of Business A's assets are no longer reflected on the books and records of a section 987 QBU (but are instead reflected on the books and records of DC1's home office). DC2, which has the U.S. dollar as its functional currency, uses the Business A assets in a business (*Business B*) that constitutes a section 987 QBU. At the time of the contribution, Business A has net unrecognized section 987 gain of $100x.

(ii) *Analysis*—(A) Under §1.987-2(c)(2)(ii), DC1's contribution of €900x of Business A's assets to DC2 is treated as a transfer of all of the assets of Business A to DC1, immediately followed by DC1's contribution of €900x of Business A's assets to DC2. The contribution of Business A's assets is a deferral event within the meaning of paragraph (g)(1) of this section because:

(*1*) The transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, resulting in a termination of the Business A QBU under §1.987-8(b)(2); and

(*2*) Immediately after the transaction, assets of Business A are reflected on the books and records of Business B, a section 987 QBU owned by a member of DC1's controlled group and a successor deferral QBU within the meaning of paragraph (g)(2) of this section. Accordingly, Business A is an original deferral QBU within the meaning of paragraph (b) of this section, and DC1 is an original deferral QBU owner of Business A within the meaning of paragraph (g)(3) of this section.

(B) Under paragraph (b)(1) of this section, DC1's taxable income in the taxable year of the deferral event includes DC1's section 987 gain or loss determined with respect to Business A under §1.987-5, except that, for purposes of applying §1.987-5, all assets of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under §1.987-8(e)). Accordingly, in the taxable year of the deferral event, Business A is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books and records at the end of the taxable year. Thus, DC1 recognizes $10x of section 987 gain in the taxable year of the deferral event. DC1's deferred section 987 gain equals $90x, which is the amount of its net unrecognized section 987 gain (which is $100x) less the amount of section 987 gain recognized by DC1 under §1.987-5 and this section (which is $10x).

(2) *Example 2: Contribution of a section 987 QBU with net unrecognized section 987 loss to a member of the controlled group when a current rate election is in effect*—(i) *Facts*. The facts are the same as in paragraph (h)(1) of this section (*Example 1)* except that a current rate election is in effect for the taxable year (and an annual recognition election is not in effect) and, at the time of the contribution, Business A has net unrecognized section 987 loss of $100x. Business A is engaged in the business of manufacturing Product X before the contribution, and Business B is engaged in the same business after the contribution. After the contribution, the €100x of assets that are reflected on the books and records of DC1's home office are not used in the business of manufacturing Product X.

(ii) *Analysis*—(A) For the reasons described in paragraph (h)(1) of this section (*Example 1*), the contribution results in a termination of the Business A QBU and a deferral event with respect to the Business A QBU, an original deferral QBU; DC1 is an original deferral QBU owner within the meaning of paragraph (g)(3) of this section; Business B is a successor deferral QBU with respect to Business A; and DC2 is a successor deferral QBU owner.

(B) Under paragraph (b)(1) of this section, for purposes of applying §1.987-5, all the assets of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under §1.987-8(e)). Accordingly, in the taxable year of the deferral event, Business A is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and DC1 is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books and records at the end of the taxable year. Thus, but for the application of §1.987-11(c), DC1 would recognize $10x of section 987 loss in the taxable year of the deferral event. Under §1.987-11(c), because a current rate election is in effect (and an annual recognition election is not in effect), the loss is instead treated as suspended section 987 loss. DC1's deferred section 987 loss equals $90x, which is the amount of its net unrecognized section 987 loss less the amount of section 987 loss suspended under §1.987-11(c) (which is $10x).

(C) Under §1.987-13(b)(1)(i), Business B is a successor suspended loss QBU because, immediately after the termination of the Business A section 987 QBU, a significant portion of the assets of Business A was reflected on the books and records of Business B (an eligible QBU), Business B continued to carry on the trade or business of Business A, and Business B was owned by DC2, a member of the same controlled group as DC1 (which is the original suspended loss QBU owner under §1.987-13(l)(1)). Therefore, under §1.987-13(b)(1)(ii), all of Business A's cumulative suspended section 987 loss (including the suspended section 987 loss resulting from the termination of Business A) becomes suspended section 987 loss with respect to Business B.

After the transaction, DC1 may recognize its suspended section 987 loss with respect to Business B under §1.987-11(e) or §1.987-13(b) through (d), as applicable.

(3) *Example 3: Election to be classified as a corporation*—(i) *Facts*. DC1 owns all of the interests in Entity A, a DE. Entity A conducts Business A, which has net unrecognized section 987 gain of $500x. Entity A elects to be classified as a corporation under §301.7701-3(c) of this chapter. As a result of the election and pursuant to §301.7701-3(g)(1)(iv) of this chapter, DC1 is treated as contributing all of the assets and liabilities of Business A to newly-formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's books and records.

(ii) *Analysis*. Under §1.987-2(c)(2)(ii), DC1's deemed contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A QBU terminates under §1.987-8(b)(2). The contribution of Business A's assets is not a deferral event within the meaning of paragraph (b) of this section because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor deferral QBU within the meaning of paragraph (g)(2) of this section due to the fact that the assets of Business A are not reflected on the books and records of a section 987 QBU immediately after the termination. In addition, the requirement of paragraph (g)(2)(iii) of this section is not met because Business A was owned by a U.S. person and the potential successor deferral QBU, which is owned by CFC1, is not owned by a U.S. person. Accordingly, DC1 recognizes section 987 gain of $500x with respect to Business A under §1.987-5 without regard to this section. Because the requirement of paragraph (g)(2)(iii) of this section is not met, the result would be the same even if the assets of Business A were transferred in a section 351 exchange to an existing foreign corporation that had a different functional currency than Business A.

(4) *Example 4: Partial recognition of deferred gain or loss*—(i) *Facts*. DC1 owns all of the interests in Entity A, a DE that conducts Business A in Country X. During year 1, DC1 contributes all of its interests in Entity A to DC2 in an exchange to which section 351 applies. At the time of the contribution, Business A has net unrecognized section 987 gain of $100x and cumulative suspended section 987 loss of $50x. After the contribution, Entity A continues to conduct the same trade or business in Country X (*Business B*). In year 3, as a result of a net transfer of property from Business B to DC2, DC2's remittance proportion with respect to Business B, as determined under §1.987-5, is 0.25.

(ii) *Analysis*—(A) For the reasons described in paragraph (h)(1) of this section *(Example 1*), the contribution of all the interests in Entity A by DC1 to DC2 results in a termination of the Business A QBU and a deferral event with respect to the Business A QBU, an original deferral QBU; DC1 is an original deferral QBU owner within the meaning of paragraph (g)(3) of this section; Business B is a successor deferral QBU with respect to Business A; DC2 is a successor deferral QBU owner; and the $100x of net unrecognized section 987 gain with respect to Business A becomes deferred section 987 gain as a result of the deferral event.

(B) Under §1.987-13(b)(1)(i), Business B is a successor suspended loss QBU because, immediately after the termination of the Business A section 987 QBU, a significant portion of the assets of Business A was reflected on the books and records of Business B (an eligible QBU), Business B continued to carry on the trade or business of Business A, and Business B was owned by DC2, a member of the same controlled group as DC1 (which is the original suspended loss QBU owner under §1.987-13(l)(1)). Therefore, under §1.987-13(b)(1)(ii), all of DC1's cumulative suspended section 987 loss with respect to Business A becomes suspended section 987 loss of DC1 with respect to Business B.

(C) Under paragraph (c)(1)(i) of this section, DC1 recognizes deferred section 987 gain in year 3 as a result of the remittance from Business B to DC2. Under paragraph (c)(1)(ii) of this section, the amount of deferred section 987 gain that DC1 recognizes is $25x, which is DC1's outstanding deferred section 987 gain of $100x with respect to Business A multiplied by the remittance proportion of 0.25 of DC2 with respect to Business B for the taxable year as determined under §1.987-5(b). In addition, under §1.987-11(e), DC1 recognizes its cumulative suspended section 987 loss to the extent of the deferred section 987 gain recognized in the same recognition grouping.

§1.987-13 Suspended section 987 loss upon terminations.

(a) *Overview*—(1) *In general*. This section provides rules relating to suspended section 987 loss of an owner with respect to a section 987 QBU or successor suspended loss QBU that terminates. Paragraph (b) of this section provides rules treating suspended section 987 loss as recognized or attributable to a successor when a section 987 QBU terminates. Paragraph (c) of this section provides rules treating suspended section 987 loss as recognized or attributable to a subsequent successor when a successor suspended loss QBU terminates. Paragraph (d) of this section provides rules regarding the recognition of suspended section 987 loss when interests in a successor suspended loss QBU owner are transferred. Paragraph (e) of this section provides rules that apply when interests in an original suspended loss QBU owner are transferred. Paragraph (f) of this section provides rules that apply when an original suspended loss QBU owner ceases to exist. Paragraph (g) of this section provides rules preventing the carryover of suspended section 987 loss in connection with certain inbound transactions. Paragraph (h) of this section provides rules that suspend section 987 loss in connection with certain outbound transactions. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides rules relating to the termination of a successor suspended loss QBU. Paragraph (k) of this section provides an anti-abuse rule. Paragraph (l) of this section provides definitions that apply for purposes of this section. Paragraph (m) of this section provides examples illustrating the rules of this section.

(2) *Ordering rule*. Paragraphs (b) through (d) of this section are applied after the application of §1.987-11(e) (loss-to-the-extent-of-gain rule).

(b) *Termination of a section 987 QBU with suspended loss*. If a section 987 QBU terminates, and at the time of termination, the owner has suspended section 987 loss with respect to the section 987 QBU (including because the termination was an outbound loss event or because net unrecognized section 987 loss became suspended section 987 loss upon termination as a result of a current rate election), then either paragraph (b)(1) or (2) of this section applies. However, this paragraph (b) does not apply to a termination that occurs in connection with a transaction described in paragraph (f) or (g) of this section.

(1) *Suspended section 987 loss becomes suspended section 987 loss with respect to a successor suspended loss QBU*—(i) *Successor suspended loss QBU*. If, immediately after the termination, a significant portion of the assets of the terminating section 987 QBU are reflected on the books and records of an eligible QBU that carries on a trade or business of the section 987 QBU and is owned by the owner of the section 987 QBU or a member of its controlled group (determined immediately after the transaction), then the eligible QBU is a successor suspended loss QBU and the rules provided in paragraph (b)(1)(ii) of this section apply.

(ii) *Attribution of suspended section 987 loss to successor suspended loss QBU*. A portion of the cumulative suspended section 987 loss with respect to the terminating section 987 QBU that is not recognized in the taxable year of the termination under §1.987-11(e) becomes suspended section 987 loss with respect to each successor suspended loss QBU. Such portion is equal to the suspended section 987 loss described in the preceding sentence, multiplied by a fraction, the numerator of which is the aggregate adjusted basis of the gross assets transferred to the successor suspended loss QBU in connection with the termination, and the denominator of which is the aggregate adjusted basis of the gross assets transferred to all successor suspended loss QBUs in connection with the termination.

(2) *Recognition of suspended section 987 loss*. If, immediately after the termination of the section 987 QBU, there is no successor suspended loss QBU under paragraph (b)(1) of this section, then the owner recognizes the cumulative suspended section 987 loss with respect to the section 987 QBU that is not recognized in the taxable year of the termination under §1.987-11(e).

(c) *Termination of a successor suspended loss QBU*. If a successor suspended loss QBU terminates (as described in paragraph (j) of this section), then either paragraph (c)(1) or (2) of this section applies. However, this paragraph (c) does not apply to a termination that occurs in connection with a transaction described in paragraph (e), (f), or (g) of this section.

(1) *Successor to the successor suspended loss QBU*—(i) *Successor suspended loss QBU*. If, immediately after the termination, a significant portion of the assets of the terminating successor suspended loss QBU (*initial successor*) are reflected on the books and records of an eligible QBU (*subsequent successor*) that carries on a trade or business of the initial successor and is owned by the original suspended loss QBU owner or a member of its controlled group (determined immediately after the transaction), then the subsequent successor is a successor suspended loss QBU and the rules provided in paragraph (c)(1)(ii) of this section apply.

(ii) *Attribution of suspended section 987 loss to successor suspended loss QBU*. A portion of the cumulative suspended section 987 loss with respect to the initial successor that is not recognized in the taxable year of the termination under §1.987-11(e) becomes suspended section 987 loss with respect to each subsequent successor. Such portion is equal to the suspended section 987 loss described in the preceding sentence, multiplied by a fraction, the numerator of which is the aggregate adjusted basis of the gross assets transferred to the subsequent successor in connection with the termination, and the denominator of which is the aggregate adjusted basis of the gross assets transferred to all subsequent successors in connection with the termination.

(2) *Recognition of suspended section 987 loss*. If, immediately after the termination of the initial successor, there is no subsequent successor that is a successor suspended loss QBU under paragraph (c)(1) of this section, then the original suspended loss QBU owner recognizes the cumulative suspended section 987 loss with respect to the initial successor that is not recognized in the taxable year of the termination under §1.987-11(e).

(d) *Transfer of successor suspended loss QBU owner*. If a successor suspended loss QBU ceases to be owned by a member of the original suspended loss QBU owner's controlled group as a result of a direct or indirect transfer, or an issuance or redemption, of an ownership interest in the successor suspended loss QBU owner, then the original suspended loss QBU owner recognizes the cumulative suspended section 987 loss with respect to the successor suspended loss QBU that is not recognized in the taxable year under §1.987-11(e).

(e) *Transfer of original suspended loss QBU owner*. If an original suspended loss QBU owner ceases to be a member of the successor suspended loss QBU owner's controlled group as a result of a direct or indirect transfer, or an issuance or redemption, of an ownership interest in the original suspended loss QBU owner, the original suspended loss QBU owner's suspended section 987 loss ceases to be attributable to any successor suspended loss QBU (but it continues to be suspended section 987 loss of the original suspended loss QBU owner). As a result, the suspended section 987 loss can be recognized by the original suspended loss QBU owner under §1.987-11(e) but cannot be recognized under paragraph (b)(2), (c)(2), or (d) of this section.

(f) *Owner ceases to exist*. If the owner of a section 987 QBU with suspended section 987 loss or an original suspended loss QBU owner ceases to exist and there is no successor under paragraph (l)(1)(ii) of this section (for example, as a result of a section 331 liquidation), then any suspended section 987 loss of the owner that is not recognized after application of the loss-to-the-extent-of-gain rule in §1.987-11(e) is eliminated and cannot be recognized.

(g) *Inbound nonrecognition transactions—no carryover of suspended section 987 loss*. If an owner of a section 987 QBU with suspended section 987 loss, or an original suspended loss QBU owner, ceases to exist in a transaction described in §1.987-8(c)(1)(ii) (inbound section 332 liquidation) or §1.987-8(c)(2)(ii) (inbound reorganization), then any suspended section 987 loss of the owner or original suspended loss QBU owner that is not recognized after application of the loss-to-the-extent-of-gain rule in §1.987-11(e) is eliminated and cannot be recognized. As a result, the distributee or acquiring corporation does not succeed to or take into account any suspended section 987 loss of the owner or original suspended loss QBU owner under section 381.

(h) *Outbound transactions—recognition or suspension of net unrecognized section 987 loss*. This paragraph (h) applies to taxable years in which neither a current rate election nor an annual recognition election is in effect.

(1) *In general*. Notwithstanding §1.987-5, if an outbound loss event occurs with respect to a section 987 QBU (an *outbound loss QBU*), the original owner of the section 987 QBU includes in taxable income in the taxable year of the outbound loss event section 987 loss with respect to the outbound loss QBU only to the extent provided in paragraph (h)(3) of this section.

(2) *Outbound loss event*. An outbound loss event means, with respect to a section 987 QBU:

(i) Any termination of the section 987 QBU as a result of a transfer by a U.S. person of assets of the section 987 QBU to a foreign person that is a member of the same controlled group as the U.S. person immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (*related foreign person*), provided that the termination would result in the recognition of section 987 loss with respect to the section 987 QBU under §1.987-5 but for this paragraph (h); or

(ii) [Reserved]

(3) *Loss recognition upon an outbound loss event*. In the taxable year of an outbound loss event with respect to an outbound loss QBU, the owner of the outbound loss QBU recognizes section 987 loss as determined under §§1.987-5 and 1.987-12(b), except that, solely for purposes of applying §1.987-5, assets and liabilities of the outbound loss QBU that, immediately after the outbound loss event, are reflected on the books and records of an eligible QBU owned by the related foreign person described in paragraph (h)(2) of this section are treated as not having been transferred and therefore as remaining on the books and records of the outbound loss QBU notwithstanding the outbound loss event.

(4) *Loss suspension upon outbound loss event*. Net unrecognized section 987 loss or deferred section 987 loss that, as a result of this paragraph (h), is not recognized in the taxable year of the outbound loss event (*outbound section 987 loss*) under §1.987-5 becomes suspended section 987 loss.

(i) [Reserved]

(j) *Termination of a successor suspended loss QBU*. For purposes of applying paragraph (c) of this section, a successor suspended loss QBU terminates if it ceases to be an eligible QBU of its owner.

(k) *Anti-abuse*. No section 987 loss is recognized under this section, §1.987-5, or §1.987-12 in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(l) *Definitions*. The following definitions apply for purposes of this section.

(1) *Original suspended loss QBU owner*—(i) *In general*. An *original suspended loss QBU owner* is the person that was the owner of a section 987 QBU before its termination in a transaction to which paragraph (b)(1) of this section applies.

(ii) *Successors*. If an original suspended loss QBU owner is a corporation (*transferor corporation*) and another corporation acquires the assets of the transferor corporation in a transaction described in section 381(a), then the acquiring corporation becomes the original suspended loss QBU owner.

(2) *Successor suspended loss QBU*. *See* paragraphs (b)(1) and (c)(1) of this section and §1.987-12(d) for rules regarding when an eligible QBU is a successor suspended loss QBU.

(3) *Successor suspended loss QBU owner*. A *successor suspended loss QBU owner* is the owner of the assets and liabilities of a successor suspended loss QBU.

(4) *Ownership interests*. The term ownership interests means stock in a corporation and partnership interests in a partnership.

(5) *Significant portion*. With respect to the assets of an eligible QBU, the term *significant portion* means a significant portion of the operating assets, determined based on all the facts and circumstances, provided that more than 30 percent of the operating assets will constitute a significant portion in all cases and less than 10 percent of the operating assets will not constitute a significant portion in all cases.

(m) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the interests in Entity A, a DE. Entity A conducts Business A, a section 987 QBU that is engaged in the business of selling Product X. Business A has the euro as its functional currency.

(1) *Example 1: Trade or business of a section 987 QBU ceases*—(i) *Facts*. Entity A's trade or business of selling Product X ceases, resulting in a termination of the Business A section 987 QBU under §1.987-8(b)(1). After the trade or business is wound up, the remaining assets are transferred to DC1 and are not used in the trade or business of selling Product X immediately following the termination. Business A has cumulative suspended section 987 loss under §1.987-11(b) of $500x.

(ii) *Analysis*. Immediately after the termination of the Business A section 987 QBU, a significant portion of Business A's assets is not reflected on the books and records of an eligible QBU that carries on a trade or business of Business A and is owned by DC1 or a member of its controlled group. Therefore, Business A has no successor suspended loss QBU under paragraph (b)(1) of this section. Consequently, DC1 recognizes the cumulative suspended section 987 loss with respect to the Business A section 987 QBU under paragraph (b)(2) of this section.

(2) *Example 2: Trade or business of a section 987 QBU is sold to a third party*—(i) *Facts*. DC1 sells all the interests in Entity A to a third party for cash. Business A has cumulative suspended section 987 loss under §1.987-11(b) of $500x.

(ii) *Analysis*. Under §1.987-2(c)(2)(ii), the sale of the Business A assets and liabilities for cash that is reflected on the books of DC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's sale of those assets and liabilities. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A section 987 QBU terminates under §1.987-8(b)(2). Immediately after the termination of the Business A section 987 QBU, a significant portion of Business A's assets is not reflected on the books and records of an eligible QBU that carries on a trade or business of Business A and is owned by DC1 or a member of its controlled group. Therefore, Business A has no successor suspended loss QBU under paragraph (b)(1) of this section. Consequently, DC1 recognizes the cumulative suspended section 987 loss with respect to the Business A section 987 QBU under paragraph (b)(2) of this section.

(3) *Example 3: Outbound loss event*—(i) *Facts*. Entity A elects to be classified as a corporation under §301.7701-3(c) of this chapter. As a result of the election and pursuant to §301.7701-3(g)(1)(iv) of this chapter, DC1 is treated as contributing all of the assets and liabilities of Business A to newly formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's books and records (which are the only books and records maintained by CFC1). CFC1 continues to use those assets in the same trade or business after the contribution (*Business B*). Neither a current rate election nor an annual recognition election is in effect. Business A has net unrecognized section 987 loss of $500x.

(ii) *Analysis*—(A) Under §1.987-2(c)(2)(ii), DC1's contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A section 987 QBU terminates under §1.987-8(b)(2). The contribution of Business A's assets to CFC1 is not a deferral event within the meaning of §1.987-12(g)(1) because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor deferral QBU within the meaning of §1.987-12(g)(2) due to the fact that the assets of Business A are not reflected on the books and records of a section 987 QBU immediately after the termination, as well as the fact that the requirement of §1.987-12(g)(2)(iii) is not met because Business A was owned by a U.S. person and the potential successor deferral QBU (Business B) is not owned by a U.S. person. The termination of the Business A section 987 QBU as a result of the transfer of the assets of Business A by a U.S. person (DC1) to a foreign person (CFC1) that is a member of DC1's controlled group is an outbound loss event described in paragraph (h)(2) of this section.

(B) Under paragraphs (h)(1) and (3) of this section, in the taxable year of the outbound loss event, DC1 includes in taxable income section 987 loss recognized with respect to Business A as determined under §1.987-5, except that, for purposes of applying §1.987-5, all assets and liabilities of Business A that are reflected on the books and records of CFC1, a related foreign person described in paragraph (h)(2) of this section, are treated as not having been transferred. Accordingly, DC1's remittance proportion with respect to Business A is 0, and DC1 recognizes no section 987 loss with respect to Business A. DC1's outbound section 987 loss is $500x, which is the amount of section 987 loss that DC1 would have recognized under §1.987-5 without regard to paragraph (h) of this section ($500x), less the amount of section 987 loss recognized by DC1 under paragraph (h)(3) of this section ($0). Under paragraph (h)(4) of this section, the $500x of outbound section 987 loss becomes suspended section 987 loss.

(C) Under paragraph (b)(1)(i) of this section, Business B is a successor suspended loss QBU because, immediately after the termination of the Business A section 987 QBU, the Business A assets are reflected on the books and records of Business B (which is the only set of books and records maintained by CFC1), Business B was an eligible QBU that continued to carry on the same trade or business as Business A did before the contribution, and Business B was owned by CFC1, a member of the same controlled group as DC (which is the original suspended loss QBU owner under paragraph (l)(1) of this section). *See* §1.987-1(b)(4)(ii) (providing that, if a corporation is solely engaged in activities that constitute a trade or business, and the corporation maintains only one set of books and records, the activities (but not the corporation) are a qualified business unit). Therefore, under paragraph (b)(1)(ii) of this section, all of Business A's suspended section 987 loss (including the suspended section 987 loss resulting from the termination of Business A) is treated as suspended section 987 loss of DC1 with respect to Business B.

§1.987-14 Section 987 hedging transactions.

(a) *Overview*. This section provides rules relating to section 987 hedging transactions. Paragraph (b) of this section provides the definition of a section 987 hedging transaction. Paragraph (c) of this section provides identification requirements for section 987 hedging transactions. Paragraph (d) of this section provides rules relating to the taxation of section 987 hedging transactions. Paragraph (e) of this section provides examples illustrating the rules of this section.

(b) *Section 987 hedging transaction*—(1) *In general*. A section 987 hedging transaction is a financial instrument or a combination or series of financial instruments (a *hedge*), that is entered into by the owner of a section 987 QBU as part of the normal course of the owner's trade or business for the purpose of managing exchange rate risk with respect to all or part of the owner's net investment in the section 987 QBU (the *hedged QBU*), provided that the requirements of paragraph (b)(2) of this section are met. If only part of a financial instrument (or combination or series of financial instruments) is described in the preceding sentence, that part is treated as a section 987 hedging transaction for purposes of this section.

(2) *Requirements*. A transaction is a section 987 hedging transaction described in paragraph (b)(1) of this section for a taxable year only if the following requirements are met.

(i) *Identification*. The hedge must be identified as a section 987 hedging transaction with respect to the hedged QBU under paragraph (c) of this section. The financial instrument or instruments that comprise the hedge must not be identified as a section 987 hedging transaction with respect to any other section 987 QBU. If only part of a financial instrument (or combination or series of financial instruments) is a section 987 hedging transaction, that part must be clearly identified.

(ii) *Current rate election*. A current rate election must be in effect for the taxable year.

(iii) *Mark-to-market method of accounting*. Section 988 gain or loss of the owner with respect to the hedge must be accounted for under a mark-to-market method of accounting (for example, under section 1256). In addition, if a member of the owner's controlled group is a party to the hedge, any section 988 gain or loss of the controlled group member with respect to the hedge must be accounted for under a mark-to-market method of accounting.

(iv) *Treatment under U.S. generally accepted accounting principles*. Foreign currency gain or loss on the hedge must be properly accounted for under generally accepted accounting principles as a cumulative foreign currency translation adjustment to shareholders' equity.

(v) *Hedge entered into by owner of the hedged QBU*. The hedge must be entered into by the owner of the hedged QBU (and not by a section 987 QBU of the owner). In the case of a hedged QBU that is owned by a member of a consolidated group, the hedge must be entered into by the member that owns the hedged QBU.

(3) *Anti-abuse rule*. If a taxpayer enters into a hedge or a related transaction with a principal purpose of effectively converting section 987 gain or loss into section 988 gain or loss (or another type of income or loss) of the owner or a related party, the hedge is not treated as a section 987 hedging transaction.

(4) *Partial termination of a section 987 hedging transaction*. If only part of a financial instrument is a section 987 hedging transaction, and a part of the financial instrument is terminated or disposed of, a proportionate part of the section 987 hedging transaction is treated as terminated or disposed of.

(c) *Identification requirements*—(1) *In general*. The owner of a hedged QBU must clearly identify the hedge as a section 987 hedging transaction with respect to the hedged QBU in its books and records on or before the close of the day on which the owner entered into the hedge. The identification must meet the requirements of §1.1221-2(f)(4) and must include the following information—

(i) The date on which the hedge is entered into by the owner of the hedged QBU and the date on which the hedge is identified as a section 987 hedging transaction;

(ii) A description of the hedge; and

(iii) Identification of the hedged QBU.

(2) *Inadvertent error*. If a hedge is not identified under paragraph (c)(1) of this section, but the hedge would otherwise qualify as a section 987 hedging transaction with respect to a hedged QBU within the meaning of paragraph (b) of this section and the taxpayer can demonstrate to the satisfaction of the Commissioner that its failure to identify the hedge was due to inadvertent error, the taxpayer may treat the hedge as a section 987 hedging transaction if all of the owner's hedges described in paragraph (b) of this section in all open years are being treated on either original or, if necessary, amended returns as section 987 hedging transactions subject to the rules of paragraph (d) of this section.

(d) *Taxation of section 987 hedging transactions*—(1) *Hedging gain or loss with respect to a hedged QBU.* If the owner of a section 987 QBU has entered into a section 987 hedging transaction with respect to the section 987 QBU, the owner's hedging gain or loss with respect to the hedged QBU for a taxable year is equal to the gain or loss that the owner would (but for the application of this paragraph (d)) recognize under section 988 with respect to the section 987 hedging transaction in the taxable year under the mark-to-market method of accounting described in paragraph (b)(2)(iii) of this section (including gain or loss that would be recognized in connection with a complete or partial disposition or termination of the section 987 hedging transaction). If only part of a financial instrument is a section 987 hedging transaction, a proportionate part of the gain or loss that would (but for the application of this paragraph (d)) be recognized under section 988 with respect to the financial instrument in the taxable year is treated as hedging gain or loss with respect to the hedged QBU. *See* paragraph (d)(3) of this section for rules relating to the determination of hedging gain or loss in the taxable year in which the hedged QBU terminates.

(2) *Adjustment to unrecognized section 987 gain or loss for the taxable year*—(i) *Hedging loss*. In a taxable year in which an owner has hedging loss with respect to a hedged QBU and has unrecognized section 987 gain for the taxable year with respect to the hedged QBU (as determined under §1.987-4(d), without regard to this paragraph (d)), the unrecognized section 987 gain for the taxable year is reduced (but not below zero) by the amount of the hedging loss. The amount of hedging loss that reduces unrecognized section 987 gain under this paragraph (d)(2)(i) is not recognized under section 988. Any hedging loss that does not reduce unrecognized section 987 gain under this paragraph (d)(2)(i) is recognized under section 988.

(ii) *Hedging gain*. In a taxable year in which an owner has hedging gain with respect to a hedged QBU and has unrecognized section 987 loss for the taxable year with respect to the hedged QBU (as determined under §1.987-4(d), without regard to this paragraph (d)), the unrecognized section 987 loss for the taxable year is reduced (but not below zero) by the amount of the hedging gain. The amount of hedging gain that reduces unrecognized section 987 loss under this paragraph (d)(2)(ii) is not recognized under section 988. Any hedging gain that does not reduce unrecognized section 987 loss under this paragraph (d)(2)(ii) is recognized under section 988.

(3) *Termination of a hedged QBU*. If the owner of a section 987 QBU has entered into a section 987 hedging transaction with respect to the section 987 QBU and the hedged QBU terminates, the owner's hedging gain or loss with respect to the hedged QBU for the taxable year is equal to the hedging gain or loss that the owner would (but for the application of this paragraph (d)) recognize with respect to the section 987 hedging transaction under the mark-to-market method of accounting described in paragraph (b)(2)(iii) of this section if the taxable year ended on the termination date. Appropriate adjustments must be made to prevent the section 988 gain or loss from being taken into account again after it is applied to reduce unrecognized section 987 gain or loss under this paragraph (d).

(e) *Examples*. The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns Business A, a section 987 QBU that has the euro as its functional currency. A current rate election is in effect for years 1 and 2, but no other elections are in effect. In year 1, DC1 had net unrecognized section 987 loss (determined under §1.987-4(b)) of $1,000x with respect to Business A, and Business A did not make a remittance in year 1. As a result, in year 2, DC1's net accumulated unrecognized section 987 loss from prior taxable years (determined under §1.987-4(c)) was $1,000x. In year 2, DC1 had unrecognized section 987 loss for the taxable year (determined under §1.987-4(d) before the application of paragraph (d) of this section) of $500x.

(1) *Example 1: Section 987 hedging transaction*—(i) *Facts*. In year 2, DC1 entered into a six-month foreign currency forward contract with an unrelated bank in the normal course of DC1's trade or business for the purpose of managing exchange rate risk with respect to DC1's net investment in Business A. On the same day, DC1 identified the forward contract as a section 987 hedging transaction with respect to Business A under paragraph (c) of this section. Under generally accepted accounting principles, currency gain or loss from the forward contract is accounted for as a cumulative translation adjustment to shareholder's equity. For Federal income tax purposes, DC1 accounts for section 988 gain or loss with respect to the forward contract under a mark-to-market method of accounting. But for the application of paragraph (d) of this section, DC1 would recognize $400x of section 988 gain with respect to the forward contract.

(ii) *Analysis*—(A) *Qualification of the hedge as a section 987 hedging transaction*. The forward contract qualifies as a section 987 hedging transaction under paragraph (b) of this section because it is a financial instrument that manages DC1's exchange rate risk with respect to Business A (the hedged QBU) as part of the normal course of DC1's trade or business, and the hedge meets the requirements of paragraph (b)(2) of this section.

(B) *Treatment of the section 987 hedging transaction*. But for the application of paragraph (d) of this section, DC1 would recognize $400x of section 988 gain with respect to the forward contract in year 2. Therefore, DC1 has $400x of hedging gain in year 2. In year 2, DC1 had unrecognized section 987 loss of $500x for the taxable year (determined under §1.987-4(d) before the application of paragraph (d) of this section). Therefore, under paragraph (d)(2)(ii) of this section, DC1's unrecognized section 987 loss for the taxable year of $500x is reduced by the $400x of hedging gain. Accordingly, DC1 has unrecognized section 987 loss of $100x for the taxable year with respect to Business A. Under §1.987-4(b), DC1 has $1,100x of net unrecognized section 987 loss in year 2 (equal to the sum of its net accumulated section 987 loss of $1,000x from prior taxable years and its unrecognized section 987 loss for the taxable year of $100x). DC1 does not recognize its hedging gain under section 988 because all of the hedging gain reduces unrecognized section 987 loss for the taxable year.

(2) *Example 2: Excess hedging gain from a section 987 hedging transaction*—(i) *Facts*. The facts are the same as in paragraph (e)(1) of this section (*Example 1*) except that, but for the application of paragraph (d) of this section, DC1 would recognize $600x of section 988 gain with respect to the forward contract.

(ii) *Analysis*. Under paragraph (d)(2)(ii) of this section, DC1's unrecognized section 987 loss for the taxable year of $500x is reduced by the hedging gain, but not below zero. Accordingly, $500x of the hedging gain is applied to reduce DC1's unrecognized section 987 loss for the taxable year to zero. DC1 has $1,000x of net unrecognized section 987 loss in year 2 under §1.987-4(b) (equal to its net accumulated section 987 loss of $1,000x from prior taxable years). The $500x hedging gain that reduces unrecognized section 987 loss for the taxable year is not recognized under section 988. The excess amount of hedging gain ($100x) is recognized by DC1 under section 988.

§1.987-15 Applicability date.

(a) *Applicability date of the section 987 regulations*—(1) *In general*. Except as provided in this section, the section 987 regulations apply to taxable years beginning after December 31, 2024.

(2) *Applicability date for a terminating QBU*. The section 987 regulations apply to the owner of a terminating QBU immediately before the section 987 QBU terminates, but only with respect to the section 987 QBU, any successor deferral QBUs or successor suspended loss QBUs (in their capacity as such), and any net unrecognized section 987 gain or loss, deferred

section 987 gain or loss, or suspended section 987 loss with respect thereto. *See* §1.987-1(h) for the definition of a terminating QBU.

(b) *Application of the section 987 regulations to taxable years beginning on or before December 31, 2024, and ending after November 9, 2023*. A taxpayer (including a taxpayer that has applied the 2016 and 2019 section 987 regulations to a prior taxable year under paragraph (c) of this section) may choose to apply the section 987 regulations to a taxable year beginning on or before December 31, 2024, and ending after November 9, 2023, provided the taxpayer and each member of its consolidated group and section 987 electing group:

(1) Consistently apply the section 987 regulations in their entirety to the taxable year and all subsequent taxable years beginning on or before December 31, 2024; and

(2) Apply the section 987 regulations on their original timely filed (including extensions) returns for the first taxable year to which the taxpayer chooses to apply the section 987 regulations.

(c) *Application of the 2016 and 2019 section 987 regulations*—(1) *In general*. A taxpayer may choose to apply the 2016 and 2019 section 987 regulations to a taxable year beginning after December 7, 2016, and beginning on or before December 31, 2024, provided the taxpayer and each member of its consolidated group and section 987 electing group:

(i) First apply the 2016 and 2019 section 987 regulations to a taxable year ending before November 9, 2023;

(ii) Consistently apply the 2016 and 2019 section 987 regulations in their entirety to all section 987 QBUs (within the meaning of prior §1.987-1(b)(2)) directly or indirectly owned (within the meaning of prior §1.987-1(b)(4)) by the taxpayer and each member of its consolidated group and section 987 electing group on the transition date for that taxable year and all subsequent taxable years before the taxable year in which the taxpayer and each member of its consolidated group and section 987 electing group apply the section 987 regulations pursuant to paragraph (a) or (b) of this section; and

(iii) Either—

(A) First applied the 2016 and 2019 section 987 regulations on their returns filed before November 9, 2023; or

(B) First apply the 2016 and 2019 section 987 regulations on their returns filed on or after November 9, 2023 and apply §1.987-10 in lieu of prior §1.987-10.

(2) *Application to section 987 QBUs not owned on the transition date*. For any taxable year in which a taxpayer applies the 2016 and 2019 section 987 regulations pursuant to paragraph (c)(1) of this section, the taxpayer may choose to apply the 2016 and 2019 section 987 regulations to any section 987 QBU (within the meaning of prior §1.987-1(b)(2)) that the taxpayer did not directly or indirectly own (within the meaning of prior §1.987-1(b)(4)) on the transition date, provided the taxpayer applies the 2016 and 2019 section 987 regulations consistently to that QBU for that taxable year and all subsequent taxable years before the taxable year in which the taxpayer applies the section 987 regulations pursuant to paragraph (a) or (b) of this section and the taxpayer either—

(i) First applied the 2016 and 2019 section 987 regulations to the section 987 QBU on its return filed before November 9, 2023; or

(ii) First applies the 2016 and 2019 section 987 regulations to the section 987 QBU on its return filed on or after November 9, 2023, and applies §1.987-10 in lieu of prior §1.987-10.

(3) *Modifications of defined terms for purposes of this paragraph (c)*. Solely for purposes of this paragraph (c)—

(i) *Application of §1.987-10 in lieu of prior §1.987-10*. For any taxpayer to which paragraph (c)(1)(iii)(B) or (c)(2)(ii) of this section applies, the term *2016 and 2019 section 987 regulations* includes §1.987-10 and not prior §1.987-10.

(ii) *Partnerships not included in section 987 electing group*. The term *section 987 electing group* does not include foreign partnerships.

(iii) *Transition date*. The term *transition date* has the meaning provided in prior §1.987-10.

(d) *Prior §1.987-12*. For the applicability dates of prior §1.987-12, *see* prior §1.987-12(j). Prior §1.987-12 applies through the end of the taxable year immediately preceding the first taxable year in which a taxpayer applies §1.987-12 pursuant to paragraph (a) or (b) of this section.

Par. 9. Section 1.988-1 is amended by:

a. Removing and reserving paragraph (a)(4);

b. Revising paragraph (a)(10)(i);

c. Removing the language "1988" in the fourth sentence of paragraph (a)(1)(iii) and adding the language "2025" in its place; and

d. Revising paragraph (i).

The revisions read as follows:

§1.988-1 Certain definitions and special rules.

(a) * * *

(10) * * *

(i) *In general*. Except as provided in paragraph (a)(10)(ii) of this section, disregarded transactions between or among the taxpayer and/or qualified business units of that taxpayer ("intra-taxpayer transactions") are not section 988 transactions. See section 987 and the regulations thereunder.

* * * * *

(i) *Applicability date*—(1) *In general*. Except as otherwise provided in this section, this section applies to taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

(2) *Paragraph (a)(10)(ii)*. Generally, paragraph (a)(10)(ii) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-15(b), a taxpayer chooses to apply §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then paragraph (a)(10)(ii) of this section applies to that taxable year. *See* §1.988-1(i), as contained in 26 CFR in part 1 in effect on April 1, 2024, for a prior applicability date for paragraph (a)(10)(ii) of this section.

Par. 10. 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) apply in determining whether an asset, liability, or item of income, gain, deduction, or loss is reflected on the books and records of a qualified business unit.

(ii) *Applicability date*. Generally, paragraph (b)(2)(i) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-15(b), a taxpayer chooses to apply §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then paragraph (b)(2)(i) of this section applies to that taxable year.

* * * * *

Par. 11. Section 1.989(a)-1 is amended by:

a. Removing and reserving paragraph (b)(2)(i)(C).

b. Revising paragraphs (b)(4), (d)(3) and (4).

The revisions read as follows:

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

* * * * *

(b) * * *

(4) *Applicability date*. Generally, paragraph (b)(2)(i) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-15(b), a taxpayer chooses to apply §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then paragraph (b)(2)(i) of this section applies to that taxable year. *See* §1.989(a)-1(b)(4), as contained in 26 CFR in part 1 in effect on April 1, 2024, for a prior applicability date for paragraph (b)(2)(i) of this section.

* * * * *

(d) * * *

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

(4) *Applicability date*. Generally, paragraph (d)(3) of this section applies to taxable years beginning after December 31, 2024. However, if pursuant to §1.987-15(b), a taxpayer applies §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then paragraph (d)(3) of this section applies to that taxable year. *See* §1.989(a)-1(d)(4), as contained in 26 CFR in part 1 in effect on April 1, 2024, for a prior applicability date for paragraph (d)(3) of this section.

* * * * *

Par. 12. Section 1.1502–13 is amended by revising paragraph (j)(9) and adding paragraphs (j)(10) and (l)(7) to read as follows:

§1.1502-13 Intercompany transactions.

* * * * *

(j) * * *

(9) *Section 987 QBUs*. No intercompany transaction is attributable to a section 987 QBU (within the meaning of §1.987-2(b)). That is, in order to produce single entity treatment, an intercompany transaction that otherwise would involve the section 987 QBU(s) of one or more members is treated instead as occurring directly between the members (without the involvement of any section 987 QBUs), and transfers are deemed to take place between each section 987 QBU and its owner (*see* §1.987-2(c)(2)(ii)). For example, if a member (M1) lends money to the section 987 QBU of another member (M2), this intercompany transaction is treated as a loan from M1 to M2 and a contribution from M2 to its section 987 QBU.

(10) *Examples*. The operating rules of this paragraph (j) are illustrated generally throughout this section, and by the following examples.

(i) *Example 1. Intercompany sale followed by section 351 transfer to member*— (A) *Facts*. S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to M for $100. M also holds the land for investment. On July 1 of Year 3, M transfers the land to B in exchange for all of B's stock in a transaction to which section 351 applies. Under section 358, M's basis in the B stock is $100. B holds the land for sale to customers in the ordinary course of business and, under section 362(b), B's basis in the land is $100. On December 1 of Year 5, M sells 20% of the B stock to X for $22. In an unrelated transaction on July 1 of Year 8, B sells 20% of the land for $22.

(B) *Definitions*. Under paragraph (b)(1) of this section, S's sale of the land to M and M's transfer of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. M has no intercompany items under paragraph (b)(2) of this section. Because B acquired the land in an intercompany transaction, B's items from the land are corresponding items to be taken into account under this section. Under the successor asset rule of paragraph (j)(1) of this section, references to the land include references to M's B stock. Under the successor person rule of paragraph (j)(2) of this section, references to M include references to B with respect to the land.

(C) *Timing and attributes resulting from the stock sale*. Under paragraph (c)(3) of this section, M is treated as owning and selling B's stock for purposes of the matching rule even though, as divisions, M could not own and sell stock in B. Under paragraph (j)(3) of this section, both M's B stock and B's land can cause S's intercompany gain to be taken into account under the matching rule. Thus, S takes $6 of its gain into account in Year 5 to reflect the $6 difference between M's $2 gain taken into account from its sale of B stock and the $8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation. Under paragraph (c)(1) of this section, S's $6 gain and M's $2 gain are treated as long-term capital gain. The gain would be capital on a separate entity basis (assuming that section 341 does not apply), and this treatment is not inconsistent with treating S, M, and B as divisions of a single corporation because the stock sale and subsequent land sale are unrelated transactions and B remains a member following the sale.

(D) *Timing and attributes resulting from the land sale*. Under paragraph (j)(3) of this section, S takes $6 of its gain into account in Year 8 under the matching rule to reflect the $6 difference between B's $2 gain taken into account from its sale of an interest in the land and the $8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation and taking into account the activities of S, M, and B with respect to the land. Thus, both S's gain and B's gain might be ordinary income as a result of B's activities. (If B subsequently sells the balance of the land, S's gain taken into account is limited to its remaining $18 of intercompany gain.)

(E) *Sale of successor stock resulting in deconsolidation*. The facts are the same as in paragraph (j)(10)(i)(A) of this section (*Example 1*), except that M sells 60% of the B stock to X for $66 on December 1 of Year 5 and B becomes a nonmember. Under the matching rule, M's sale of B stock results in $18 of S's gain being taken into account (to reflect the difference between M's $6 gain taken into account and the $24 recomputed gain). Under the acceleration rule, however, the entire $30 gain is taken into account (to reflect B becoming a nonmember, because its basis in the land reflects M's $100 cost basis from the prior intercompany transaction). Under paragraph (j)(4) of this section, the attributes of S's gain are determined by treating S, M, and B as divisions of a single corporation. Because M's cost basis in the land will be reflected by B as a nonmember, all of S's gain is treated as from the land (rather than a portion being from B's stock), and B's activities with respect to the land might therefore result in S's gain being ordinary income.

(ii) *Example 2. Intercompany sale of member stock followed by recapitalization*—(A) *Facts*. Before becoming a member of the P group, S owns P stock with a basis of $70. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, S sells the P stock to M for $100. On December 1 of Year 5, P acquires M's original P stock in exchange for new P stock in a recapitalization described in section 368(a)(1)(E).

(B) *Timing and attributes*. Although P's basis in the stock acquired from M is eliminated under paragraph (f)(4) of this section, the new P stock received by M is exchanged basis property (within the meaning of section 7701(a)(44)) having a basis under section 358 equal to M's basis in the original P stock. Under the successor asset rule of paragraph (j)(1) of this section, references to M's original P stock include references to M's new P stock. Because it is still possible to take S's intercompany item into account under the matching rule with respect to the successor asset, S's gain is not taken into account under the acceleration rule as a result of the basis elimination under paragraph (f)(4) of this section. Instead, the gain is taken into account based on subsequent events with respect to M's new P stock (for example, a subsequent distribution or redemption of the new stock).

(iii) *Example 3. Back-to-back intercompany transactions—matching*—(A) *Facts*. S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to M for $90. M also holds the land for investment. On July 1 of Year 3, M sells the land for $100 to B, and B holds the land for sale to customers in the ordinary course of business. During Year 5, B sells all of the land to customers for $105.

(B) *Timing*. Under paragraph (b)(1) of this section, S's sale of the land to M and M's sale of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. Under paragraph (j)(4) of this section, S, M and B are treated as divisions of a single corporation for purposes of determining the timing of their items from the intercompany transactions. See also paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany gain into account). Thus, S's $20 gain and M's $10 gain are both taken into account in Year 5 to reflect the difference between B's $5 gain taken into account with respect to the land and the $35 recomputed gain (the gain that B would have taken into account if the intercompany sales had been transfers between divisions of a single corporation, and B succeeded to S's $70 basis).

(C) *Attributes*. Under paragraph (j)(4) of this section, the attributes of the intercompany items and corresponding items of S, M, and B are also determined by treating S, M, and B as divisions of a single corporation. For example, the attributes of S's and M's intercompany items are determined by taking B's activities into account.

(iv) *Example 4. Back-to-back intercompany transactions—acceleration*—(A) *Facts*. During Year 1, S performs services for M in exchange for $10 from M. S incurs $8 of employee expenses. M capitalizes the $10 cost of S's services under section 263 as part of M's cost to acquire real property from X. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. M holds the real property for investment and, on July 1 of Year 5, M sells it to B at a gain. B also holds the real property for investment. On December 1 of Year 8, while B still owns the real property, P sells all of M's stock to X and M becomes a nonmember.

(B) *M's items*. M takes its gain into account immediately before it becomes a nonmember. Because the real property stays in the group, the acceleration rule redetermines the attributes of M's gain under the principles of the matching rule as if B sold the real property to an affiliated corporation that is not a member of the group for a cash payment equal to B's adjusted basis in the real property, and S, M, and B were divisions of a single corporation. Thus, M's gain is capital gain.

(C) *S's items*. Under paragraph (b)(2)(ii) of this section, S includes the $8 of expenses in determining its $2 intercompany income. In Year 1, S takes into account $8 of income and $8 of expenses. Under paragraph (j)(4) of this section, appropriate adjustments must be made to treat both S's performance of services for M and M's sale to B as occurring between divisions of a single corporation. Thus, S's $2 of intercompany income is not taken into account as a result of M becoming a nonmember, but instead will be taken into account based on subsequent events (e.g., under the matching rule based on B's sale of the real property to a nonmember, or under the acceleration rule based on P's sale of the stock of S or B to a nonmember). See the successor person rules of paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany income into account).

(D) *Sale of S's stock*. The facts are the same as in paragraph (j)(9)(iv)(A) of this section (*Example 4*), except that P sells all of S's stock (rather than M's stock) and S becomes a nonmember on July 1 of Year 5. S's remaining $2 of intercompany income is taken into account immediately before S becomes a nonmember. Because S's intercompany income is not from an intercompany sale, exchange, or distribution of property, the attributes of the intercompany income are determined on a separate entity basis. Thus, S's $2 of intercompany income is ordinary income. M does not take any of its intercompany gain into account as a result of S becoming a nonmember.

(E) *Intercompany income followed by intercompany loss*. The facts are the same as in paragraph (j)(9)(iv)(A) of this section (*Example 4*), except that M sells the real property to B at a $1 loss (rather than a gain). M takes its $1 loss into account under the acceleration rule immediately before M becomes a nonmember. But see § 1.267(f)-1 (which might further defer M's loss if M and B remain in a controlled group relationship after M becomes a nonmember). Under paragraph (j)(4) of this section appropriate adjustments must be made to treat the group as if both intercompany transactions occurred between divisions of a single corporation. Accordingly, P's sale of M stock also results in S taking into account $1 of intercompany income as capital gain to offset M's $1 of corresponding capital loss. The remaining $1 of S's intercompany income is taken into account based on subsequent events.

(v) *Example 5. Successor group*—(A) *Facts*. On January 1 of Year 1, B borrows $100 from S in return for B's note providing for $10 of interest annually at the end of each year, and repayment of $100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note. On that date, X acquires all of P's stock and the former P group members become members of the X consolidated group.

(B) *Successor*. Under paragraph (j)(5) of this section, although B's note ceases to be an intercompany obligation of the P group, the note is not treated as satisfied and reissued under paragraph (g) of this section as a result of X's acquisition of P stock. Instead, the X consolidated group succeeds to the treatment of the P group for purposes of paragraph (g) of this section, and B's note is treated as an intercompany obligation of the X consolidated group.

(vi) *Example 6. Liquidation—80% distributee*—(A) *Facts*. X has had preferred stock described in section 1504(a)(4) outstanding for several years. On January 1 of Year 1, S buys all of X's common stock for $60, and B buys all of X's preferred stock for $40. X's assets have a $0 basis and $100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502-34, section 332 applies to both S and B. Under section 337, X has no gain or loss from its liquidating distribution to S. Under sections 336 and 337(c), X has a $40 gain from its liquidating distribution to B. B has a $40 basis under section 334(a) in the assets received from X, and S has a $0 basis under section 334(b) in the assets received from X.

(B) *Intercompany items from the liquidation*. Under the matching rule, X's $40 gain from its liquidating distribution to B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§ 1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under section 337(c), X recognizes gain or loss only with respect to the assets distributed to B. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's $40 intercompany gain. The gain will be taken into account by S under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain to S does not govern the allocation of any other attributes.)

(vii) *Example 7. Liquidation—no 80% distributee*—(A) *Facts*. X has only common stock outstanding. On January 1 of Year 1, S buys 60% of X's stock for $60, and B buys 40% of X's stock for $40. X's assets have a $0 basis and $100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under § 1.1502-34, section 332 applies to both S and B. Under sections 336 and 337(c), X has a $100 gain from its liquidating distributions to S and B. Under section 334(b), S has a $60 basis in the assets received from X and B has a $40 basis in the assets received from X.

(B) *Intercompany items from the liquidation*. Under the matching rule, X's $100 intercompany gain from its liquidating distributions to S and B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§ 1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's $40 intercompany gain with respect to the assets distributed to B, and B succeeds to X's $60 intercompany gain with respect to the assets distributed to S. The gain will be taken into account by S and B under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain does not govern the allocation of any other attributes.)

(viii) *Example 8: Loan by section 987 QBU*—(A) *Facts*. S owns all the interests in DE1, a disregarded entity operating a business that is a section 987 QBU (S QBU) whose functional currency is the euro. S has net unrecognized section 987 gain with respect to S QBU. In year 1, S QBU lends €100 to B with interest due annually. B makes interest payments on the loan to S QBU in years 1 through 3. In year 3, B repays the loan and recognizes section 988 loss of $12 on the loan repayment. All payments are made in euros, and B recognizes no section 988 gain or loss on the euros it uses to pay the interest and principal. B is never insolvent within the meaning of section 108(d)(3). Other than with respect to the loan, there are no transfers between S and S QBU during years 1 through 3, and neither S nor B had any other foreign currency gain or loss. Neither S nor B has made an election under section 988 or the section 988 regulations.

(B) *Analysis*—(*1*) *Loan*. Under paragraph (j)(9) of this section, the loan is treated as a transfer from S QBU to S and a loan directly between S and B. Specifically, S is treated as receiving a transfer of €100 from S QBU in year 1; S is then treated as lending €100 directly to B. For purposes of §1.987-2, the loan is attributable to S, not to S QBU. As an intercompany loan, S's loan to B is subject to the rules of this section. Because there is a remittance from S QBU to S in year 1, S recognizes section 987 gain under §1.987-5.

(*2*) *Interest payments*. While the loan is outstanding, each of B's interest payments to S QBU is treated as an interest payment from B to S, followed by a transfer from S to S QBU. Under the matching rule in paragraph (c) of this section, S's intercompany interest income offsets B's corresponding interest expense. *See* paragraph (g)(7)(ii)(A)(*2*) of this section (*Example 1*). Since the functional currency of both S and B is the dollar, if B recognizes any section 988 gain or loss on the interest payments, S will recognize an offsetting amount of section 988 loss or gain. Because the only transfer between S and S QBU in year 2 is from S to S QBU, there is no remittance from S QBU to S and S does not recognize section 987 gain under §1.987-5.

(*3*) *Repayment*. Upon the year 3 repayment of the loan, B is treated as repaying €100 to S, and S is treated as transferring €100 to S QBU. Since the functional currency of both S and B is the dollar, and B recognizes section 988 loss of $12 on the loan repayment, S will recognize an offsetting section 988 gain of $12. Because the only transfers between S and S QBU in year 3 are from S to S QBU, there is no remittance from S QBU to S and S does not recognize section 987 gain under §1.987-5.

(4) *Summary*. Overall, the group's taxable income includes S's section 987 gain in year 1 (the section 988 inclusions offset). This result is consistent with the treatment of a single corporation that borrows from its section 987 QBU.

(C) *Loan sold to non-member*. The facts are the same as in paragraph (j)(10)(viii)(A) of this section, except that, in year 3, S QBU sells the loan to unrelated X for €90, reflecting an increase in prevailing market interest rates. Up until the sale, the analysis is the same as in paragraphs (j)(10)(viii)(B)(*1*) and (*2*) of this section. Because the loan is attributable to S (*see* paragraphs (j)(9) and (j)(10)(viii)(B)(*1*) of this section), the sale is treated as a sale by S. Under paragraph (g)(3) of this section, immediately before the sale, B is deemed to satisfy and reissue the loan for its fair market value of €90. As a result, B takes into account cancellation of indebtedness income, and S takes into account an offsetting amount of ordinary loss. *See* paragraph (g)(7)(ii) (*Example 2*) of this section. If there is currency gain or loss, S and B take into account offsetting amounts of gain and loss under section 988 (subject to the limitation of §1.988-2(b)(8)). Because S has a basis of €90 in the new loan, S recognizes no gain or loss on the sale to X. S is then treated as transferring the €90 to S QBU.

(D) *Party becomes a nonmember*. The facts are the same as in paragraph (j)(10)(viii)(A) of this section, except that, in year 3, B becomes a nonmember. Up until B leaves the group, the analysis is the same as in paragraphs (j)(10)(viii)(B)(*1*) and (*2*) of this section. Immediately before B becomes a nonmember, B is deemed to satisfy and reissue the loan for its fair market value under paragraph (g)(3) of this section, with the same consequences as described in paragraph (j)(10)(viii)(C) of this section. When B becomes a nonmember, the loan (which is no longer an intercompany obligation) ceases to be subject to paragraph (j)(9) of this section. If the loan is attributable to S QBU under §1.987-2, S is treated as transferring the loan to S QBU.

(ix) *Example 9: Sale of property by section 987 QBU*—(A) *Facts*. M1 owns all the interests in DE1, a disregarded entity operating a business that is a section 987 QBU (M1 QBU) whose functional currency is the euro. M1 has net unrecognized section 987 gain with respect to M1 QBU. M1 QBU sells property to M2 for €100 in year 1.

(B) *Analysis*—(*1*) *In general*. Under paragraph (j)(9) of this section, the sale of property is treated as a transfer of the property from M1 QBU to M1, followed by an exchange of the property for €100 directly between M1 and M2, and a transfer of the €100 from M1 to M1 QBU.

(*2*) *Distribution*. M1 QBU is treated as transferring the property to M1.

(*3*) *Exchange*. M1 is then treated as selling the property to M2 for €100. M1 takes into account its intercompany gain or loss on the property under the rules of this section. M2 recognizes intercompany section 988 gain or loss on its exchange of €100 for the property. *See* paragraph (b)(1)(iii) of this section for property exchanges between members.

(*4*) *Contribution*. Finally, M1 is treated as transferring the €100 to M1 QBU. Because M1's basis in the €100 equals its fair market value, M1 has a corresponding section 988 gain or loss of zero upon the contribution. *See* §1.988-1(a)(10). Both the transfer of the property from M1 QBU to M1 and the transfer of the €100 from M1 to M1 QBU are taken into account in determining whether there is a remittance from M1 QBU to M1 in year 1 and whether M1 recognizes section 987 gain under §1.987-5.

(*5*) *Summary*. Overall, in year 1, M1 may take into account section 987 gain if the transfers between M1 and M1 QBU result in a remittance, and M2 takes into account section 988 gain or loss on the €100. This result is consistent with the treatment of a single corporation that purchases property from its section 987 QBU.

(l) * * *

(7) *Applicability date*. Generally, paragraph (j)(9) of this section applies to taxable years beginning after December 31, 2024, for which the original Federal income tax return is due (without extensions) after December 11, 2024. However, if pursuant to §1.987-15(b), a taxpayer chooses to apply §§1.987-1 through 1.987-15 to a taxable year before the first taxable year described in §1.987-15(a)(1), then paragraph (j)(9) of this section applies to that taxable year and subsequent years.

Douglas W. O'Donnell,
Deputy Commissioner.

Approved: November 20, 2024

Aviva R. Aron-Dine,
Deputy Assistant Secretary of the Treasury (*Tax Policy*).

(Filed by the Office of the Federal Register December 10, 2024, 8:45 a.m., and published in the issue of the Federal Register for December 11, 2024, 89 FR 100138)

26 CFR 1.987-0 through 26 CFR 1.987-15

TD 10020

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Reissuance of State or Local Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that address when tax-exempt bonds are treated as retired for certain Federal income tax purposes. The final regulations are necessary to unify and to clarify existing guidance on this subject. The final regulations affect State and local governments that issue tax-exempt bonds.

DATES: *Effective date*: These regulations are effective on December 30, 2024.

Applicability date: For dates of applicability, *see* §1.150-3(f).

FOR FURTHER INFORMATION CONTACT: Zoran Stojanovic, (202) 317-6980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Authority

This document contains final regulations that amend the Income Tax Regulations (26 CFR part 1) by adding final regulations under section 150 and amending the regulations under section 1001 of the Internal Revenue Code (Code) to provide rules for determining when tax-exempt bonds are treated as retired for purposes of sections 103 and 141 through 150 of the Code (final regulations).

These final regulations are promulgated under the express delegation of authority in section 7805(a) of the Code, which authorizes the Secretary of the Treasury or her delegate to "prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

Background

On December 31, 2018, a notice of proposed rulemaking (REG-141739-08) regarding retirement of tax-exempt bonds was published in the ***Federal Register*** (83 FR 67701) (proposed regulations). No public hearing was requested or held. Five public comments responding to the proposed regulations were received and are available at *https://www.regulations.gov* or upon request. After careful consideration of all the written comments, the proposed regulations are adopted as amended by this Treasury decision in response to such comments as described in the *Summary of Comments and Explanation of Revisions*.

1. *Overview*

In general, under section 103, interest received by the holders of certain bonds issued by State and local governments is exempt from Federal income tax. To qualify for the tax exemption, a bond issued by a State or local government must satisfy various eligibility requirements under sections 141 through 150 at the time of issuance of the bond. If the issuer and holder agree after issuance to modify the terms of a tax-exempt bond significantly, the original bond may be treated as having been retired and exchanged for a newly issued, modified bond. Similarly, if the issuer or its agent acquires and resells the bond, the bond may be treated as having been extinguished upon acquisition and replaced upon resale with a newly issued bond.

The term "reissuance" commonly refers to the effect of a transaction in which a new bond is deemed to be issued in place of an old bond as a result of retirement of the old bond pursuant to such an exchange or extinguishment. In the case of a reissuance, the reissued bond must be retested for qualification under sections 103 and 141 through 150. The reissuance of an issue of tax-exempt bonds may result in various negative consequences to the issuer, such as changes in yield for purposes of the arbitrage investment yield restrictions under section 148(a), acceleration of arbitrage rebate payment obligations under section 148(f), and change-in-law risk.

2. *Tender Option Bonds*

Tender option bonds and variable rate demand bonds (collectively, tender option bonds) have special features that present reissuance questions. Specifically, tender option bonds have original terms that provide for a tender option interest rate mode, as described in this paragraph. Issuers of tax-exempt bonds often preauthorize several different interest rate modes in the bond documents and retain an option to switch interest rate modes under parameters set forth in the bond documents. During a tender option mode, tender option bonds have short-term interest rates that are reset periodically at various short-term intervals (typically, every seven days) based on the current market rate necessary to remarket the bonds at par. In connection with each resetting of the interest rate, the holder of a tender option bond has a right or requirement to tender the bond back to the issuer or its agent for purchase at par. Tender option bonds generally are structured with these short-term features supported by put options to enable the bonds to be eligible for purchase by tax-exempt money market funds pursuant to 17 CFR 270.2a-7 (Rule 2a-7 under the Investment Company Act of 1940).

Tender option bonds also may have interest rate mode conversion options that permit the issuer or conduit borrower to change the interest rate mode on the bonds from a tender option mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, the holder of a tender option bond typically has the right or requirement to tender the bond for purchase at par.

Tender option bonds generally have third-party liquidity facilities from banks or other liquidity providers to ensure that there is sufficient cash to repurchase the bonds upon a holder's tender, and they also commonly have credit enhancement from bond insurers or other third-party guarantors. Upon a holder's exercise of its tender rights in connection with either a resetting of the interest rate during a tender option mode or a conversion to another interest rate mode, a remarketing agent or a liquidity provider typically will acquire the bonds subject to the tender and resell the bonds either to the same bondholders or to others willing to purchase such bonds.

3. *Existing Guidance*

To address reissuance questions related to tax-exempt bonds, on December 27, 1988, the Department of the Treasury (Treasury Department) and the IRS published Notice 88-130, 1988-2 CB 543, which provides rules for determining when a tax-exempt bond is retired for purposes of sections 103 and 141 through 150. Notice 88-130 provides in part that a tax-exempt bond is retired when there is a change to the terms of the bond that results in a disposition of the bond for purposes of section 1001. In addition, Notice 88-130 provides special rules for retirement of certain tender option bonds that meet a definition of the term "qualified tender bond."

On June 26, 1996, the Treasury Department and the IRS published final regulations under §1.1001-3 of the Income Tax Regulations (1996 final regulations) in the ***Federal Register*** (61 FR 32926). The 1996 final regulations provide rules for determining whether a modification of the terms of a debt instrument, including a tax-exempt bond, results in an exchange for purposes of section 1001. In recognition of a need to coordinate the interaction of the prior guidance in Notice 88-130 with the 1996 final regulations for particular tax-exempt bond purposes, the Treasury Department and the IRS stated their intention to issue regulations under section 150 on this subject in the preamble of the 1996 final regulations. *See* 61 FR 32930.

On April 14, 2008, the Treasury Department and the IRS published Notice 2008-41, 2008-1 CB 742. Like Notice 88-130, Notice 2008-41 provides rules for determining when a tax-exempt bond is retired for purposes of sections 103 and 141 through 150 and includes special rules for qualified tender bonds. While the retirement standards provided in these two notices are similar, Notice 2008-41 was intended to coordinate the retirement standards for tax-exempt bond purposes with the 1996 final regulations on modifications of debt instruments under §1.1001-3 and to be more administrable than Notice 88-130. In order to preserve flexibility and to limit potential unintended consequences during the 2008 financial crisis, Notice 2008-41 permitted issuers to apply either notice. Generally, under Notice 2008-41, a tax-exempt bond is retired when a significant modification to the terms of the bond occurs under §1.1001-3, the bond is acquired by or on behalf of its issuer, or the bond is otherwise redeemed or retired. The notice clarifies that, for purposes of these retirement standards, the purchase of a tax-exempt bond by a third-party guarantor or third-party liquidity facility provider pursuant to the terms of the guarantee or liquidity facility is not treated as a purchase or other acquisition by or on behalf of a governmental issuer. Although these general rules apply to a qualified tender bond, Notice 2008-41 also provides that certain features of qualified tender bonds will not result in a retirement. In Notice 2008-41, the Treasury Department and the IRS reiterated their intention to provide guidance on the retirement of tax-exempt bonds in regulations under section 150.

The proposed regulations provide rules for determining when tax-exempt bonds are treated as retired for purposes of sections 103 and 141 through 150. The proposed regulations also amend §1.1001-3(a)(2) of the 1996 final regulations to conform that section to the special rules in the proposed regulations for retirement of qualified tender bonds.

Summary of Comments and Explanation of Revisions

After consideration of the public comments, the Treasury Department and the IRS adopt the proposed regulations as amended by this Treasury decision. This section of the preamble discusses the public comments and the revisions made in the final regulations in response to those comments.

1. *General Rules for Retirement of a Tax-Exempt Bond*

The proposed regulations generally provide standards for determining when a tax-exempt bond is retired for purposes of sections 103 and 141 through 150, including certain special rules for determining when qualified tender bonds are retired.

One comment suggested expanding the scope of the final regulations to cover taxable tax-advantaged bonds, such as direct pay build America bonds and tax credit bonds, because some of those bonds were also issued as tender option bonds that would benefit from the special rules for qualified tender bonds. The authorizations for these taxable tax-advantaged bonds, however, have been very limited in both time and amount, and very few of these bonds have been issued as tender option bonds. Furthermore, section 13404 of Public Law 115-97, 131 Stat. 2054, 2138 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act, repealed the existing authority in the Code for taxable tax-advantaged bonds. Because no taxable tax-advantaged bonds currently may be issued and very few historically have been issued as tender option bonds, the Treasury Department and the IRS have determined that expanding the scope of the final regulations to include those bonds lacks sufficient justification. Accordingly, the final regulations do not adopt this comment.

The proposed regulations generally provide that a tax-exempt bond is retired if a significant modification to the terms of the bond occurs under §1.1001-3, the issuer or an agent acting on its behalf acquires the bond in a manner that liquidates or extinguishes the bondholder's investment in the bond, or the bond is otherwise redeemed (for example, redeemed at maturity).

The final regulations make one technical change to the second general rule regarding debt extinguishment to remove the reference to the "bondholder's investment" and thus to focus more clearly on the merger of interests and attendant extinguishment that occurs when an issuer acquires its own bond either directly or through an agent.

Two comments recommended allowing an issuer to make an election to treat a tax-exempt bond as retired and reissued under the final regulations. These comments noted that it is sometimes unclear whether a transaction results in the retirement and reissuance of a tax-exempt bond. The comments described several specific situations in which such an election could address this uncertainty. The Treasury Department and the IRS recognize that such an election could reasonably reduce the burden on issuers in certain specific situations. However, the Treasury Department and the IRS have concerns that an unrestricted right to elect retirement and reissuance of tax-exempt bonds could result in unintended consequences. In response to this comment and to provide flexibility to address this issue in appropriate, tailored circumstances, the final regulations authorize the Commissioner to publish guidance in the Internal Revenue Bulletin that allows issuers to elect to treat tax-exempt bonds as retired and reissued in specific circumstances for purposes of sections 103 and 141 through 150.

2. *Exceptions to Retirement of a Tax-Exempt Bond*

The proposed regulations provide three exceptions to the operation of the general rules that limit retirements of tax-exempt bonds. Two of these exceptions prevent the special features of tender option bonds from resulting in a retirement. A third exception applies to all tax-exempt bonds.

A. *Definition of qualified tender bond*

The first two exceptions in the proposed regulations apply to qualified tender bonds, which are defined to cover tender option bonds that meet certain requirements. Specifically, a qualified tender bond is subject to certain limitations on interest rate, timing of interest payments, and maturity. A qualified tender bond must also include a qualified tender right. The proposed regulations generally define a qualified tender right as a right or obligation of the holder of a bond to tender the bond for purchase by the issuer, its agent, or another party at a purchase price equal to par plus any accrued interest. Under the proposed regulations, a qualified tender right must also require the issuer or its remarketing agent to redeem the bond or to use reasonable best efforts to resell the bond within the 90 days of the tender at a purchase price equal to par plus any accrued interest.

Four comments urged the Treasury Department and the IRS to amend the definition of a qualified tender right in the final regulations to allow a bond to be resold at a premium or discount price relative to the par amount of the bond (rather than just at a price equal to par as under the proposed regulations) when the qualified tender right is exercised in connection with a conversion of the interest rate mode to a fixed rate for the remaining term of the bond. The comments noted that, when a long-term fixed rate bond is originally issued at par, a sustained upward trend in interest rates can result in the bond having market discount as it is resold in the secondary market. If that market discount exceeds the permitted de minimis amount, the discount will be taxed as ordinary income to the holder. Premium included in the sale price of a long-term fixed rate tax-exempt bond serves as a buffer against market discount as interest rates rise over time. Accordingly, qualified tender bonds resold at a premium upon conversion of the interest rate mode on the bonds to a fixed rate to maturity generally have greater market demand and a lower yield than they would have if resold at par. The comments also noted that, even when an issue of fixed rate tax-exempt bonds is resold at an aggregate net premium price, certain bonds within the issue may be resold at a discount. The comments further noted that Notice 2008-41 permitted qualified tender bonds to be resold at a premium or a discount upon conversion of the interest rate mode to a fixed rate to maturity and treated the premium received by the issuer upon resale of the bonds as additional sale proceeds for purposes of the arbitrage investment restrictions under section 148. The final regulations adopt this comment.

One comment pointed out a technical discrepancy in the proposed regulations under which a bond may be purchased pursuant to a qualified tender right by the issuer, the issuer's agent, or another party, whereas the bond must be resold under the terms of a qualified tender right by the issuer or a remarketing agent. The comment recommended that the final regulations clarify this technical issue in the definition of a qualified tender right so that the parties that may purchase the tendered bond (that is, the issuer, the issuer's agent, or another party) are also permitted to resell the bond. The comment advised against use of the term "remarketing agent" on the grounds that the party charged with reselling the bond may not be an agent of the issuer and the resale may be a private placement rather than a remarketing. The final regulations adopt this comment.

B. *Exceptions to retirement of a qualified tender bond*

A qualified tender bond has two features that could result in retirement of the bond under the general rules for retirement in the proposed regulations. First, the existence or exercise of a qualified tender right in connection with an alteration under the terms of the bond could cause the alteration to be a modification under §1.1001-3 and, if significant, that modification would result in retirement of the qualified tender bond under §1.150-3(b)(1) of the proposed regulations. For example, when accompanied by a tender right, an exercise of the issuer's option to change the interest rate or the interest rate mode under the terms of the bond could be a modification under the rule in §1.1001-3(c)(2)(iii) for alterations that result from the exercise of an option because the holder's resulting right to put the bond to the issuer or its agent under the qualified tender right upon the interest rate conversion could cause the issuer's option to fail to qualify as a unilateral option under §1.1001-3(c)(3)(i). Similarly, an issuer may be uncertain as to whether the periodic change in interest rate that occurs pursuant to the terms of a bond operating in a tender option mode could be a modification under §1.1001-3 when accompanied by a tender right. To address these circumstances, the proposed regulations provide a special exception that avoids retirement by disregarding a qualified tender right for purposes of applying §1.1001-3 to determine whether an alteration of a qualified tender bond constitutes a significant modification under §1.1001-3 that results in retirement of the bond.

One comment requested that the final regulations clarify whether this exception applies to a qualified tender right arising in connection with any alteration of the terms of the bond or only to a qualified tender right arising in connection with a change in interest rate or interest rate mode. The scope of the analogous provisions in Notices 88-130 and 2008-41 was limited to circumstances covering changes in the interest rate or interest rate mode only. The Treasury Department and the IRS intended for this special rule to be similarly limited in scope. In response to the comment, the final regulations clarify that the special rule for disregarding a qualified tender right in applying §1.1001-3 to a qualified tender bond applies only for the purpose of determining whether an alteration of the interest rate or interest rate mode pursuant to the terms of a qualified tender bond results in a retirement. The determination of whether any other alteration to the terms of a qualified tender bond, such as a change in maturity or collateral, results in a retirement under §1.150-3(b)(1)(i) is made under the general rules in §1.1001-3 without the benefit of the special exception in §1.150-3(c)(1), even if the alteration occurs contemporaneously with a change in interest rate or interest rate mode on the bond.

One comment recommended that the final regulations include several additional exceptions to the general rule under §1.150-3(b)(1) that a bond is retired for purposes of sections 103 and 141 through 150 when a significant modification occurs under §1.1001-3. Specifically, this comment requested that the final regulations include a rule from Notice 2008-41 that a modification that changes the collateral or credit enhancement on a nonrecourse tax-exempt bond is significant only if the change results in a change in payment expectations under §1.1001-3(e)(4)(vi). This special rule involved an accommodation for circumstances in the 2008 financial crisis. This comment also requested that the final regulations retain the exception in Notice 88-130 for qualified corrective changes. This exception from 1988 preceded the significant modification standard under §1.1001-3, which was finalized in the 1996 final regulations. In most circumstances, these qualified corrective changes would not be significant modifications under §1.1001-3. Further, a significant purpose of the final regulations is to improve administrability in a complex area of law by integrating the rules for retirement of a tax-exempt bond as closely as possible with the existing rules under §1.1001-3. Accordingly, the final regulations do not adopt these comments.

The second feature of a qualified tender bond that could result in retirement of the bond under the general rules for retirement in the proposed regulations is the feature under which an issuer or its agent may acquire the bond upon the holder's exercise of the qualified tender right. The general rules for retirement treat an acquisition of a bond by an issuer or an issuer's agent in a manner that extinguishes the bond as a retirement of the bond. To address this circumstance, the proposed regulations provide an exception under which the acquisition of a qualified tender bond pursuant to the exercise of a qualified tender right will not result in retirement, provided that neither the issuer nor its agent holds the bond for longer than 90 days. One comment recommended expanding this special rule to cover all tax-exempt bonds rather than just qualified tender bonds. This exception is limited to qualified tender bonds because the rate-setting mechanism on those bonds may require the issuer or its agent to purchase a tendered bond if a buyer for the bond cannot be found when the bond is tendered. The Treasury Department and the IRS have adopted this limited exception for the narrowly defined class of qualified tender bonds because the acquisition of those bonds occurs pursuant to the ordinary operation of the rate-setting mechanism on those bonds. In addition, qualified tender bonds represent a significant structured type of bonds in the tax-exempt bond market tailored to money market fund investors and the Treasury Department and the IRS have supported this structure with accommodating special rules consistently in all of the existing guidance in this area. Other tax-exempt bonds do not rely on this exception for the ordinary operation of their rate-setting mechanism. The Treasury Department and the IRS decline to expand this exception to allow issuers to hold their own bonds more generally because of concerns regarding the implications for the debt extinguishment principle. Accordingly, the final regulations do not adopt this comment.

One comment recommended continuing a special rule from Notice 2008-41 that modified the definition of program investment for purposes of arbitrage investment restrictions under §1.148-1(b). Ordinarily, this definition prohibits a conduit borrower of tax-exempt bond proceeds from purchasing the bonds that financed the conduit loan in an amount that is related to the conduit loan. Notice 2008-41 modified this rule so that a conduit borrower could purchase any auction rate bonds that financed the conduit loan, provided the conduit borrower purchased the bonds to facilitate liquidity under adverse market conditions. This special rule permitted conduit borrowers to buy those bonds to address extraordinary circumstances in the 2008 financial crisis and to increase liquidity at a time of market crisis involving the collapse of the auction rate bond market and downgrades of bond insurers. The Treasury Department and the IRS decline to extend this special rule beyond the conditions under which the rule was promulgated. Accordingly, the final regulations do not adopt this comment.

C. *Additional exceptions for all tax-exempt bonds*

The proposed regulations also provide an exception to the general rules of retirement for all tax-exempt bonds. This exception, carried forward from Notice 2008-41, provides that acquisition of a tax-exempt bond by a guarantor or liquidity facility provider acting as the issuer's agent does not result in retirement of the bond if the acquisition is pursuant to the terms of the guarantee or liquidity facility and the guarantor or liquidity facility provider is not a related party (as defined in §1.150-1(b)) to the issuer. No public comments were received on this provision. The final regulations adopt this provision without change.

The proposed regulations provide that a tax-exempt bond is retired for purposes of sections 103 and 141 through 150 when a significant modification occurs under §1.1001-3. Section 1.1001-3(e)(5)(i) generally provides that, subject to the special rule in §1.1001-3(f)(7), a modification of a debt instrument that results in an instrument or property right that is not debt for Federal income tax purposes is a significant modification. Section 1.1001-3(f)(7)(ii)(A) generally provides that, in determining whether a modification of a debt instrument results in an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the modification is not taken into account. One comment recommended that, when new bonds are issued and the proceeds are used to currently refund outstanding bonds, issuers be allowed to apply the credit deterioration rule in §1.1001-3(f)(7) to treat the new bonds as a continuation of the refunded bonds for purposes of sections 103 and 141 through 150. The Treasury Department and the IRS have concluded that there is not sufficient justification to expand the scope of the final regulations to include rules for new issuances of tax-exempt bonds. Accordingly, the final regulations do not adopt this comment.

3. *Effect of Retirement of a Tax-Exempt Bond*

The proposed regulations prescribe certain consequences for a bond that is retired pursuant to a deemed exchange under §1.1001-3 or retired following the acquisition of the bond by the issuer or the issuer's agent. Upon a deemed exchange under §1.1001-3, the bond is treated as a new bond issued at the time of the significant modification as determined under §1.1001-3. Upon an issuer's acquisition of its own bond, absent any special rule, the bond is extinguished and retired. One comment recommended permitting an issuer that purchases its own tax-exempt bond to treat the resale of that bond as a refunding of the bond extinguished by the purchase. The comment suggested that the issuer be permitted to allocate the proceeds from the resale of the bond to the expenditure incurred in the purchase of the bond under rules similar to the rules for using proceeds of tax-exempt bonds to "reimburse" previous expenditures under the reimbursement expenditure rules in §1.150-2. Section 1.150-2(g)(1), however, specifically prohibits using bond proceeds to reimburse expenditures incurred in repayment of tax-exempt bonds. Modification of the reimbursement rules to encompass refundings of extinguished and retired bonds is beyond the scope of the final regulations. The final regulations do not adopt this comment.

4. *Applicability Dates*

Under the proposed regulations, the final rules would apply to events and actions taken with respect to bonds that occur on or after the date that is 90 days after the date of publication of the final regulations in the ***Federal Register***. The proposed regulations further state that issuers may apply the proposed regulations to events and actions taken with respect to bonds that occur before that date. One comment recommended applying the final regulations only to bonds issued after the applicability date of the final regulations. This comment noted that outstanding bonds are structured to avoid retirement under the existing guidance and potentially might not avoid retirement under the final regulations. The Treasury Department and the IRS are concerned that this approach would continue the application of the disparate existing guidance in this area for a substantial period of time for the entire current outstanding volume of tax-exempt bonds in the municipal bond market. The principal goals of the final regulations are to unify, clarify, and improve the administrability of the existing guidance on retirement of tax-exempt bonds. The Treasury Department and the IRS have determined that publishing the final regulations without also obsoleting Notice 88-130 and Notice 2008-41 would undermine the unifying and streamlining purposes of the final regulations. In addition, the final regulations and Notice 2008-41 are similar and generally should produce similar results in most cases outside of special circumstances involving the 2008 financial crisis. Accordingly, the final regulations do not adopt this comment.

However, to provide a longer transition period for outstanding tax-exempt bonds, the final regulations provide a period of one year from the date the final regulations are published in the ***Federal Register*** during which issuers may continue to apply Notice 88-130 or Notice 2008-41. As a result, the final regulations apply to events occurring and actions taken with respect to bonds on or after December 30, 2025, though an issuer may choose to apply the final regulations to events occurring and actions taken with respect to bonds on or after December 30, 2024.

Effect on Other Documents

Notice 88-130 and Notice 2008-41 are obsolete as of December 30, 2025.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (RFA), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. The final regulations affect State and local governments that issue tax-exempt bonds. States are not considered small entities for purposes of the RFA but small governmental jurisdictions (jurisdictions with populations less than 50,000) are considered small entities. The Treasury Department and the IRS do not have data on how many small governmental jurisdictions may be affected by these regulations, but it may be a substantial number.

Even if a substantial number of small entities are affected, the economic impact of these regulations will not be significant. These final regulations consolidate and clarify the existing guidance on retirement and reissuance of tax-exempt bonds published in Notices 88-130 and 2008-41. Therefore, these final regulations will not create additional obligations for, or impose an economic impact on, a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small governmental jurisdictions and no comments were received.

III. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. These regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

IV. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The final regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

V. *Congressional Review Act*

Pursuant to the Congressional Review Act (5 U.S.C. 801 et seq.), the Office of Information and Regulatory Affairs designated this rule as not a major rule, as defined by 5 U.S.C. 804(2).

Statement of Availability of IRS Documents

Any IRS Revenue Procedure, Revenue Ruling, Notice, or other guidance cited in this document is published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

Drafting Information

The principal author of these regulations is Zoran Stojanovic of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.150-3 is added to read as follows:

§1.150-3 Retirement standards for state and local bonds.

(a) *General purpose and scope*. This section provides rules to determine when a tax-exempt bond is retired solely for purposes of sections 103 and 141 through 150 of the Internal Revenue Code (Code).

(b) *Retirement of a tax-exempt bond*—(1) *General rules*. Except as otherwise provided in paragraph (c) of this section, a tax-exempt bond is retired when:

(i) A significant modification of the bond occurs under §1.1001-3;

(ii) The issuer or its agent acquires the bond in a manner that extinguishes the bond; or

(iii) The bond is otherwise redeemed (for example, redeemed at maturity).

(2) *Elective retirement*. In guidance published in the Internal Revenue Bulletin (*see* §601.601(d)(2)(ii)(*a*) of this chapter), the Commissioner may set forth specific circumstances under which an issuer may elect to treat a tax-exempt bond as retired for purposes of sections 103 and 141 through 150 of the Code.

(c) *Exceptions to general rules for retirement of a tax-exempt bond*—(1) *Qualified tender right disregarded for certain purposes*. In applying §1.1001-3 to a qualified tender bond for purposes of paragraph (b)(1)(i) of this section, both the existence and exercise of a qualified tender right are disregarded for purposes of determining whether an alteration of the interest rate or interest rate mode that occurs pursuant to the terms of the bond is a modification. Thus, an issuer's exercise of an option to alter the interest rate or interest rate mode on a qualified tender bond generally is not a modification under §1.1001-3 because the alteration occurs by operation of the terms of the bond and the holder's resulting right to put the bond to the issuer or the issuer's agent pursuant to the disregarded qualified tender right does not prevent the issuer's option from qualifying as a unilateral option under §1.1001-3(c)(3) that would not give rise to a modification.

(2) *Acquisition pursuant to a qualified tender right*. An acquisition of a qualified tender bond by the issuer or its agent does not result in the retirement of the bond under paragraph (b)(1)(ii) of this section if the acquisition is pursuant to the operation of a qualified tender right and neither the issuer nor its agent continues to hold the bond after the close of the 90-day period beginning on the date of the tender.

(3) *Acquisition of a tax-exempt bond by a guarantor or liquidity facility provider*. An acquisition of a tax-exempt bond by a guarantor or liquidity facility provider acting on the issuer's behalf does not result in the retirement of the bond under paragraph (b)(1)(ii) of this section if the acquisition is pursuant to the terms of the guarantee or liquidity facility and the guarantor or liquidity facility provider is not a related party (as defined in §1.150-1(b)) to the issuer.

(d) *Effect of retirement*. If a bond is retired pursuant to paragraph (b)(1)(i) of this section (that is, in a transaction treated as an exchange of the bond for a bond with modified terms), the bond is treated as a new bond issued at the time of the modification as determined under §1.1001-3. If the issuer or its agent resells a bond retired pursuant to paragraph (b)(1)(ii) of this section, the bond is treated as a new bond issued on the date of resale. The rules of §1.150-1(d) apply to determine if the new bond is part of a refunding issue.

(e) *Definitions*. For purposes of this section, the following definitions apply:

(1) *Issuer* means the State or local governmental unit (as defined in §1.103-1) that actually issues the tax-exempt bond and any related party (as defined in §1.150-1(b)) to the actual issuer (as distinguished, for example, from a conduit borrower that is not a related party to the actual issuer).

(2) *Qualified tender bond* means a tax-exempt bond that, pursuant to the terms of the bond, has all of the following features:

(i) During each authorized interest rate mode, the bond bears interest at a fixed interest rate, a qualified floating rate under §1.1275-5(b), or an objective rate for a tax-exempt bond under §1.1275-5(c)(5);

(ii) Interest on the bond is unconditionally payable (as defined in §1.1273-1(c)(1)(ii)) at periodic intervals of no more than one year;

(iii) The bond has a stated maturity date that is not later than 40 years after the issue date of the bond; and

(iv) The bond includes a qualified tender right.

(3) *Qualified tender right* means a right or obligation of a holder of a tax-exempt bond pursuant to the terms of the bond to tender the bond for purchase as described in this paragraph (e)(3). The purchaser under the tender may be the issuer, its agent, or another party. The tender right is available on at least one date before the stated maturity date. For each such tender, the purchase price of the bond is equal to par (plus any accrued interest). Following each such tender, the issuer, its agent, or another party either redeems the bond or uses reasonable best efforts to resell the bond within the 90-day period beginning on the date of the tender. Upon any such resale, the resale price of the bond is equal to the par amount of the bond (plus any accrued interest), except that, if the tender right is exercised in connection with a conversion of the interest rate mode on the bond to a fixed rate for the remaining term of the bond, the bond may be resold at any price, including a premium price above the par amount of the bond or a discount price below the par amount of the bond (plus any accrued interest). Any premium received by the issuer pursuant to such a resale is treated solely for purposes of the arbitrage investment restrictions under section 148 of the Code as additional sale proceeds of the bonds.

(f) *Applicability date*—(1) *General applicability.* This section applies to events occurring and actions taken with respect to bonds on or after December 30, 2025.

(2) *Permissive applicability.* An issuer may choose to apply this section to events occurring and actions taken with respect to bonds on or after December 30, 2024.

Par. 3. Section 1.1001-3 is amended by revising paragraph (a)(2) to read as follows:

§1.1001-3 Modifications of debt instruments.

(a) * * *

(2) *Tax-exempt bonds*. For special rules governing whether tax-exempt bonds are retired for purposes of sections 103 and 141 through 150 of the Internal Revenue Code, *see* §1.150-3.

* * * * *

Douglas W. O'Donnell,
Deputy Commissioner.

Approved: December 8, 2024.

Aviva R. Aron-Dine,
Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register December 27, 2024, 8:45 a.m., and published in the issue of the Federal Register for December 30, 2024)

Part III

Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

Notice 2025-1

This notice provides guidance on the corporate bond monthly yield curve, the corresponding spot segment rates used under § 417(e)(3), and the 24-month average segment rates under § 430(h)(2) of the Internal Revenue Code. In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning before 2008 and the 30-year Treasury weighted average rate under § 431(c)(6)(E)(ii)(I).

YIELD CURVE AND SEGMENT RATES

Section 430 specifies the minimum funding requirements that apply to single-employer plans (except for CSEC plans under § 414(y)) pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan's target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates ("segment rates"), each of which applies to cash flows during specified periods. To the extent provided under § 430(h)(2)(C)(iv), these segment rates are adjusted by the applicable percentage of the 25-year average segment rates for the period ending September 30 of the year preceding the calendar year in which the plan year begins.[1] However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates.

Section 1.430(h)(2)-1(d) provides rules for determining the monthly corporate bond yield curve,[2] and § 1.430(h)(2)-1(c) provides rules for determining the 24-month average corporate bond segment rates used to compute the target normal cost and the funding target. Consistent with the methodology specified in § 1.430(h)(2)-1(d), the monthly corporate bond yield curve derived from November 2024 data is in Table 2024-11 at the end of this notice. The spot first, second, and third segment rates for the month of November 2024 are, respectively, 4.66, 5.25, and 5.57.

The 24-month average segment rates determined under § 430(h)(2)(C)(i) through (iii) must be adjusted pursuant to § 430(h)(2)(C)(iv) to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates. Those percentages are 95% and 105% for plan years beginning in 2023, 2024 and 2025. For this purpose, any 25-year average segment rate that is less than 5% is deemed to be 5%. The 25-year average segment rates for plan years beginning in 2023, 2024 and 2025 were published in Notice 2022-40, 2022-40 I.R.B. 266, Notice 2023-66, 2023-40 I.R.B. 992, and Notice 2024-67, 2024-41 I.R.B. 726, respectively.

24-MONTH AVERAGE CORPORATE BOND SEGMENT RATES

The three 24-month average corporate bond segment rates applicable for December 2024 without adjustment for the 25-year average segment rate limits are as follows:

24-Month Average Segment Rates Without 25-Year Average Adjustment

Applicable Month	First Segment	Second Segment	Third Segment
December 2024	5.01	5.26	5.36

The adjusted 24-month average segment rates set forth in the chart below reflect § 430(h)(2)(C)(iv) of the Code. The 24-month averages applicable for December 2024, adjusted to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates in accordance with § 430(h)(2)(C)(iv) of the Code, are as follows:

Adjusted 24-Month Average Segment Rates

For Plan Years Beginning In	Applicable Month	First Segment	Second Segment	Third Segment
2023	December 2024	5.01	5.26	5.74
2024	December 2024	5.01	5.26	5.59
2025	December 2024	5.01	5.26	5.50

[1] Pursuant to § 433(h)(3)(A), the third segment rate determined under § 430(h)(2)(C) is used to determine the current liability of a CSEC plan (which is used to calculate the minimum amount of the full funding limitation under § 433(c)(7)(C)).

[2] For months before February 2024, the monthly corporate bond yield curve was determined in accordance with Notice 2007-81, 2007-44 I.R.B. 899. Section 1.430(h)(2)-1(d) generally adopts the methodology for determining the monthly corporate bond yield curve under Notice 2007-81 but includes two enhancements to take into account subsequent changes in the bond market. Those enhancements are described in the preamble to TD 9986 (89 FR 2127).

30-YEAR TREASURY SECURITIES INTEREST RATES

Section 431 specifies the minimum funding requirements that apply to multiemployer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in § 431(c)(6)(A), based on the plan's current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this purpose must be no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88-73, 1988-2 C.B. 383, provides guidelines for determining the weighted average interest rate. The rate of interest on 30-year Treasury securities for November 2024 is 4.54 percent. The Service determined this rate as the average of the daily determinations of yield on the 30-year Treasury bond maturing in August 2054 determined each day through November 5, 2024 and the yield on the 30-year Treasury bond maturing in November 2054 determined each day for the balance of the month. For plan years beginning in December 2024, the weighted average of the rates of interest on 30-year Treasury securities and the permissible range of rates used to calculate current liability are as follows:

Treasury Weighted Average Rates

For Plan Years Beginning In	30-Year Treasury Weighted Average	Permissible Range 90% to 105%
December 2024	3.76	3.38 to 3.95

MINIMUM PRESENT VALUE SEGMENT RATES

In general, the applicable interest rates under § 417(e)(3)(D) are segment rates computed without regard to a 24-month average. Section 1.417(e)-1(d)(3) provides guidelines for determining the minimum present value segment rates. Pursuant to that section, the minimum present value segment rates determined for November 2024 are as follows:

Minimum Present Value Segment Rates

Month	First Segment	Second Segment	Third Segment
November 2024	4.66	5.25	5.57

DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the IRS participated in the development of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Tony Montanaro at 626-927-1475 (not toll-free numbers).

Table 2024-11

Monthly Yield Curve for November 2024

Derived from November 2024 Data

Maturity	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*
0.5	4.67	20.5	5.53	40.5	5.57	60.5	5.62	80.5	5.65
1.0	4.65	21.0	5.53	41.0	5.58	61.0	5.62	81.0	5.65
1.5	4.63	21.5	5.53	41.5	5.58	61.5	5.62	81.5	5.65
2.0	4.62	22.0	5.53	42.0	5.58	62.0	5.62	82.0	5.65
2.5	4.62	22.5	5.53	42.5	5.58	62.5	5.63	82.5	5.65
3.0	4.63	23.0	5.53	43.0	5.58	63.0	5.63	83.0	5.65
3.5	4.65	23.5	5.53	43.5	5.58	63.5	5.63	83.5	5.65
4.0	4.67	24.0	5.53	44.0	5.59	64.0	5.63	84.0	5.65
4.5	4.70	24.5	5.53	44.5	5.59	64.5	5.63	84.5	5.65
5.0	4.74	25.0	5.53	45.0	5.59	65.0	5.63	85.0	5.65
5.5	4.77	25.5	5.53	45.5	5.59	65.5	5.63	85.5	5.65
6.0	4.82	26.0	5.52	46.0	5.59	66.0	5.63	86.0	5.65
6.5	4.86	26.5	5.52	46.5	5.59	66.5	5.63	86.5	5.65
7.0	4.90	27.0	5.52	47.0	5.59	67.0	5.63	87.0	5.65
7.5	4.95	27.5	5.52	47.5	5.60	67.5	5.63	87.5	5.65
8.0	4.99	28.0	5.52	48.0	5.60	68.0	5.63	88.0	5.65
8.5	5.03	28.5	5.52	48.5	5.60	68.5	5.63	88.5	5.65
9.0	5.07	29.0	5.52	49.0	5.60	69.0	5.63	89.0	5.65
9.5	5.11	29.5	5.52	49.5	5.60	69.5	5.63	89.5	5.65
10.0	5.15	30.0	5.52	50.0	5.60	70.0	5.64	90.0	5.65
10.5	5.18	30.5	5.53	50.5	5.60	70.5	5.64	90.5	5.65
11.0	5.21	31.0	5.53	51.0	5.60	71.0	5.64	91.0	5.65
11.5	5.24	31.5	5.53	51.5	5.61	71.5	5.64	91.5	5.65
12.0	5.27	32.0	5.54	52.0	5.61	72.0	5.64	92.0	5.66
12.5	5.30	32.5	5.54	52.5	5.61	72.5	5.64	92.5	5.66
13.0	5.33	33.0	5.54	53.0	5.61	73.0	5.64	93.0	5.66
13.5	5.35	33.5	5.54	53.5	5.61	73.5	5.64	93.5	5.66
14.0	5.37	34.0	5.55	54.0	5.61	74.0	5.64	94.0	5.66
14.5	5.39	34.5	5.55	54.5	5.61	74.5	5.64	94.5	5.66
15.0	5.41	35.0	5.55	55.0	5.61	75.0	5.64	95.0	5.66
15.5	5.43	35.5	5.55	55.5	5.61	75.5	5.64	95.5	5.66
16.0	5.44	36.0	5.56	56.0	5.61	76.0	5.64	96.0	5.66
16.5	5.46	36.5	5.56	56.5	5.62	76.5	5.64	96.5	5.66
17.0	5.47	37.0	5.56	57.0	5.62	77.0	5.64	97.0	5.66
17.5	5.48	37.5	5.56	57.5	5.62	77.5	5.64	97.5	5.66
18.0	5.49	38.0	5.57	58.0	5.62	78.0	5.64	98.0	5.66
18.5	5.50	38.5	5.57	58.5	5.62	78.5	5.64	98.5	5.66
19.0	5.51	39.0	5.57	59.0	5.62	79.0	5.64	99.0	5.66
19.5	5.52	39.5	5.57	59.5	5.62	79.5	5.65	99.5	5.66
20.0	5.52	40.0	5.57	60.0	5.62	80.0	5.65	100.0	5.66

Additional Time for Partnerships to Provide Complete Forms 8308 for Section 751(a) Exchanges Occurring in Calendar Year 2024

Notice 2025-2

I. PURPOSE

This notice provides relief similar to the relief provided in Notice 2024-19, 2024-5 I.R.B. 627, from penalties under § 6722 of the Internal Revenue Code[1] for failures by certain partnerships to furnish correct payee statements. Specifically, this notice grants relief if a partnership with unrealized receivables or inventory items described in § 751(a) (§ 751 property) fails to furnish Part IV of Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, to the transferor and transferee in a § 751(a) exchange (described in section II of this notice) occurring in calendar year 2024 by the due date specified in § 1.6050K-1(c)(1). This relief applies only if the partnership furnishes to the transferor and transferee by the due dates specified in section III of this notice (1) a correct copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, and (2) a correct copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under § 1.6050K-1(c).

II. BACKGROUND

Generally, § 6050K and § 1.6050K-1 require a partnership with § 751 property to provide information to each transferor and transferee that are parties to a sale or exchange of an interest in the partnership (or portion thereof) in which any money or other property received by a transferor from a transferee in exchange for all or part of the transferor's interest in the partnership is attributable to § 751 property (§ 751(a) exchange). Section 1.6050K-1(a)(1) provides that partnerships are required to report each § 751(a) exchange on Form 8308. Generally, § 1.6050K-1(f)(1) provides that a partnership is required to file Form 8308 as an attachment to its Form 1065, *U.S. Return of Partnership Income*, for the taxable year of the partnership that includes the last day of the calendar year in which the § 751(a) exchange took place. Form 8308 is due at the time for filing the partnership return, including extensions.

In addition, § 1.6050K-1(c)(1) provides that each partnership that is required to file a Form 8308 must furnish a statement to the transferor and transferee by the later of (1) January 31 of the year following the calendar year in which the § 751(a) exchange occurred, or (2) 30 days after the partnership has received notice of the exchange as specified under § 6050K and § 1.6050K-1. A partnership must use a copy of the completed Form 8308 as the required statement unless the Form 8308 contains information for more than one § 751(a) exchange. Section 1.6050K-1(c)(1) provides that if the partnership does not use the Form 8308 as the required statement, the partnership must furnish a statement that includes the information required to be shown on the Form 8308 with respect to the § 751(a) exchange to which the person to whom the statement is furnished is a party.

Section 6722 imposes a penalty for failure to furnish correct payee statements on or before the required date, and for any failure to include all of the information required to be shown on the statement or the inclusion of incorrect information. For these purposes, payee statements include statements required to be furnished to transferors and transferees under § 6050K. *See* § 6724(d)(2)(P). Section 6724 provides an exception to the imposition of a penalty under § 6722 if it is shown that the failure is due to reasonable cause and not to willful neglect.

On November 30, 2020, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published T.D. 9926, 85 FR 76910, which amended § 1.6050K-1(c)(2) to require a partnership to furnish to a transferor partner the information necessary for the transferor to make the transferor partner's required statement in § 1.751-1(a)(3). Among other items, § 1.751-1(a)(3) requires a transferor partner in a § 751(a) exchange to submit with the transferor partner's income tax return a statement setting forth the amount of gain or loss attributable to § 751 property. In October 2023, the IRS released a revised version of Form 8308. Consistent with the requirements in § 1.6050K-1(c)(2), Part IV of the October 2023 Form 8308 requires a partnership to report, among other items, the partnership's deemed sale § 751 gain or loss, deemed sale § 1(h)(5) collectibles gain, and deemed sale § 1(h)(6) unrecaptured § 1250 gain, as well as the transferor partner's share of such amounts. In October 2024, the IRS released a revised version of Form 8308. Part IV of the October 2024 Form 8308 still requires a partnership to report, among other items, the partnership's deemed sale § 751 gain or loss, deemed sale § 1(h)(5) collectibles gain, and deemed sale § 1(h)(6) unrecaptured § 1250 gain, as well as the transferor partner's share of such amounts.

Since the issuance of the October 2023 Form 8308, concerns have been expressed to the Treasury Department and the IRS that many partnerships will be unable to furnish the information required in Part IV of the Form 8308 to transferors and transferees by the January 31 due date, because, in many cases, partnerships will not have all of the information required by Part IV of the Form 8308 by January 31 of the year following the calendar year in which the § 751(a) exchange occurred. On January 11, 2024, the IRS released Notice 2024-19, which provided relief from penalties under § 6722 for partnerships with § 751(a) exchanges occurring during calendar year 2023.

III. GRANT OF RELIEF

.01 The Treasury Department and the IRS are aware that many partnerships continue to lack information needed to comply with the reporting requirements in a timely manner. As a result, with respect to § 751(a) exchanges occurring during cal-

[1] Unless otherwise specified, all "section" or "§" references are to sections of the Internal Revenue Code or to the Income Tax Regulations (26 CFR part 1).

endar year 2024, the IRS will not impose penalties under § 6722 solely for failure to furnish Form 8308 with a completed Part IV by the due date specified in § 1.6050K-1(c)(1) for a partnership that meets the following requirements.

(1) The partnership must timely and correctly furnish to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of—

(a) January 31, 2025, or

(b) 30 days after the partnership is notified of the § 751(a) exchange.

(2) The partnership must furnish to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under § 1.6050K-1(c), by the later of—

(a) the due date of the partnership's Form 1065 (including extensions), or

(b) 30 days after the partnership is notified of the § 751(a) exchange.

.02 The relief provided in this notice applies only with respect to a partnerships' furnishing of a Form 8308 to the transferor and transferee in a § 751(a) exchange made during calendar year 2024. This notice does not provide relief with respect to a transferor partner's failure to furnish the notification to the partnership required by § 1.6050K-1(d). In addition, this notice does not provide relief with respect to filing Form 8308 as an attachment to a partnership's Form 1065; as such, this notice does not provide relief from penalties under § 6721 for failure to file correct information returns.

IV. DRAFTING INFORMATION

The principal authors of this notice are Jeremy M. Brown and Benjamin H. Weaver of the Office of Associate Chief Counsel (Partnerships and Special Industries). Other personnel from the Treasury Department and IRS participated in its development. For further information please call (202) 317-5279 (not a toll-free number).

Application of the Simplified and Streamlined Approach under Section 482

Notice 2025-4

SECTION 1. PURPOSE

The purpose of this notice is to announce that the Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") intend to issue proposed regulations that, for purposes of applying section 482, provide a new method for pricing certain controlled transactions involving baseline marketing and distribution activities. The approach for pricing these activities, referred to herein as the simplified and streamlined approach ("SSA"), is described in a report of the Organization for Economic Cooperation and Development ("OECD") titled, "Pillar One – Amount B: Inclusive Framework on BEPS"[1] and published on February 19, 2024 (the "Report"). Because some aspects of the SSA may require updating over time with respect to the economic analysis that underlies the SSA (*see* section 5.4 of the Report), some aspects of the SSA may be addressed more appropriately in sub-regulatory guidance (such as, for example, a revenue procedure) that would be incorporated by reference into the regulations. The Treasury Department and the IRS expect that the proposed regulations would not substantively diverge from any aspect of the Report. Therefore, while this notice does not restate or address every element of the Report, the Treasury Department and IRS intend the proposed regulations to implement the substance of the Report in its entirety.

This notice also provides guidance concerning application of the SSA to in-scope transactions undertaken by parties subject to U.S. tax with respect to those transactions before issuance of those proposed regulations. As discussed in sections 3.01 and 6.02 of this notice, U.S. taxpayers may rely on the SSA, as set forth in the Report (as supplemented by the Statements, described in section 2.02 of this notice), and subject to the rules described in sections 3 and 4 of this notice, for their U.S. tax reporting for taxable years beginning on or after January 1, 2025, and before proposed regulations are published in the Federal Register.

SECTION 2. BACKGROUND

.01 Section 482

Section 482 of the Internal Revenue Code permits the Commissioner of the IRS ("Commissioner") to make allocations necessary to clearly reflect income or prevent tax avoidance with respect to controlled transactions. *See also* Treas. Reg. § 1.482-1(a)(1) (first sentence). The authority to make adjustments under section 482 is broad. For example, the Commissioner may make such adjustments with respect to transactions that otherwise qualify for nonrecognition under other provisions of the Code (*see*, *e.g.*, Treas. Reg. § 1.482-1(f)(1)(iii)). For adjustments under section 482 to which the arm's length standard applies, that standard is set forth in Treasury Regulation section 1.482-1(b). In addition to establishing the arm's length standard under section 482 through regulations, the Treasury Department and IRS have also promulgated detailed guidance for the application of the arm's length standard with respect to specific types of transactions. *See* Treas. Reg. §§ 1.482-2 through 1.482-9. That guidance includes simplification measures, including the safe haven interest rate under Treasury Regulation section 1.482-2(a)(2)(iii) and the services cost method under Treasury Regulation section 1.482-9(b).

.02 The Development of the SSA

In an increasingly globalized economy, multinational enterprises manage extensive value chains across multiple jurisdictions that frequently involve baseline marketing and distribution activities. Disputes regarding the pricing of these activities can impose significant financial and compliance burdens on taxpayers and significant administrative burdens on tax authorities, and the costs of such disputes

[1] Available at https://www.oecd.org/en/publications/pillar-one-amount-b_21ea168b-en/full-report.html (last accessed Dec.16, 2024).

are sometimes disproportionate to the amounts at stake and the difficulty of the pricing challenges. For some jurisdictions, these problems can be exacerbated when tax administrations are under-resourced. The Report addresses these concerns by providing guidance designed to simplify and streamline the application of transfer pricing rules for baseline marketing and distribution activities.

The SSA is similar to the comparable profits method under Treasury Regulation sections 1.482-3(a)(4), 1.482-5, and 1.482-9(a)(5) and (f) (referred to in the Report as the transactional net margin method as that method is known in the Guidelines). Like the safe haven interest rate and the services cost method, the SSA is a simplification measure that reflects a carefully balanced tradeoff between reliability and administrability. However, unlike those other simplification measures, the SSA determines a return based on comparables and is sensitive to material factual differences between the comparables and tested parties. As a result, the SSA is expected to closely approximate the result under the best method in most cases, and material differences in the results (under the SSA versus the best method), if they occur, are further expected to be minimal and uncommon. The SSA aims to alleviate administrative burdens, reduce compliance costs, reduce the likelihood of lengthy, expensive, and unnecessary cross-border tax disputes, and resolve more efficiently any disputes that nonetheless arise, thereby increasing tax certainty for both tax administrations and taxpayers. Accordingly, to the extent that the SSA may be less reliable than the best method in some cases, that reduction in reliability is expected to be modest and offset by the benefits of simplification and streamlining arising from the SSA.

The guidance in the Report regarding "Special considerations for baseline distribution activities" has been incorporated into the OECD Transfer Pricing Guidelines for Multinational Enterprises[2] (the "Guidelines") as an Annex to Chapter IV. *See* Report, p.5 (first paragraph). The Report was subsequently supplemented by two statements on June 17, 2024, the "Statement on the definitions of qualifying jurisdiction within the meaning of section 5.2 and section 5.3 of the simplified and streamlined approach"[3] and the "Statement on the definition of covered jurisdiction for the Inclusive Framework political commitment on Amount B"[4] (collectively the "Statements"). The former Statement provides text that has been incorporated into the Guidelines to replace placeholder definitions in the Report. The latter Statement clarifies the Introduction of the Report.[5]

SECTION 3. IMPLEMENTATION OF THE SSA

.01 General Overview

This section 3 provides an overview of what transactions may be within the scope of the SSA, in general, as well as the rules that future regulations would provide for when and how the SSA can be applied to such transactions for U.S. tax purposes.

The Report states that every jurisdiction may choose whether to implement the SSA. A jurisdiction that implements the SSA may choose from two options. Under Option 1, the SSA can apply only if, among other considerations, a taxpayer elects for it to apply. Under Option 2, a taxpayer can elect to apply the SSA as under Option 1, but the tax administration of the Distributor Country that has implemented the SSA also has the right to apply the SSA even if the taxpayer does not elect to apply it.

Under both options, taxpayers retain flexibility when structuring their transactions to fall within or outside of the scope of the SSA. For example, if the United States were to promulgate final rules consistent with the SSA, U.S. federal income tax principles would apply in evaluating the substance and form of the relevant transactions under all facts and circumstances for the purpose of determining whether such transactions are in scope. As is always the case under general U.S. federal income tax principles, before applying the section 482 regulations to determine whether a transfer price with respect to a purported controlled transaction is arm's length, it would first need to be determined whether a controlled transaction has occurred and, if so, what the terms of that transaction are. This analysis is required regardless of whether the relevant transactions are the same as transactions that occurred before the adoption of the SSA, or whether a taxpayer has restructured or otherwise purported to change the nature or terms of its distribution activities in order to come within the scope of the SSA. Similarly, U.S. tax rules would apply in requiring arm's length compensation for any controlled transactions that occur in connection with a restructuring, regardless of whether such transactions accomplish the restructuring itself or are ongoing following the restructuring.

The Treasury Department and the IRS intend to issue proposed regulations that, at minimum, are consistent with the Option 1 version of the SSA, which would permit taxpayers that are subject to U.S. tax with respect to in-scope transactions (that is, both U.S. Distributors and U.S. Related Suppliers) to elect (as described in section 4.06 of this notice) to apply the SSA for taxable years beginning on or after January 1, 2025. The Treasury Department and the IRS continue to consider whether proposed regulations should also permit the IRS to apply the SSA to in-scope transactions consistent with Option 2.

Section 5 of this notice contains a list of defined terms. Terms used in this notice that are not defined in section 5 and that are also used in the Report have the same meaning as that provided in the Report. For purposes of this notice, references to

[2] Available at https://www.oecd.org/en/publications/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en.html (last accessed Dec. 16, 2024).

[3] Available at https://www.oecd.org/content/dam/oecd/en/publications/support-materials/2024/02/pillar-one-amount-b_41a41e1e/statement-qualifying-jurisdiction-definitions-section-5-2-section-5-3-simplified-streamlined-approach.pdf (last accessed Dec. 16, 2024).

[4] Available at https://www.oecd.org/content/dam/oecd/en/publications/support-materials/2024/02/pillar-one-amount-b_41a41e1e/statement-covered-jurisdiction-definition-inclusive-framework-commitment-amount-b.pdf (last accessed Dec. 16, 2024).

[5] Because a version of the Guidelines containing the content of the Report and supplemented by the Statements has not been published as of the publication of this notice (the current version of the Guidelines was published in January 2022), references herein to the contents of the Report and Statements are made to those latter documents directly.

the Commissioner shall be to the director of field operations or other applicable delegate.

.02 Qualification for Application of the SSA

For U.S. taxpayers, the process of applying the SSA with respect to a controlled transaction would involve several key steps:

(1) First, the controlled transaction must fit within a category of qualifying transactions.

(2) Second, if the transaction is a qualifying transaction, it must also be an in-scope transaction. For purposes of determining whether a qualifying transaction is also an in-scope transaction under section 482, the upper bound of the operating expenses-to-revenues scoping criterion in paragraph 13.b. of the Report is 30% if (a) the Distributor is a U.S. Distributor or (b) the Distributor Country has not adopted the SSA. If the Distributor is a non-U.S. Distributor, and the Distributor Country has adopted the SSA, then the upper bound is the upper bound specified by the law of the Distributor Country, but no lower than 20% and no higher than 30%.

(3) Third, if the qualifying transaction is determined to be an in-scope transaction, then for purposes of applying the SSA for U.S. law, an election would need to be made as described in section 4.06 of this notice.

(4) Fourth, the taxpayer must maintain permanent books of account and records that are adequate to permit verification by the Commissioner that the controlled transactions with respect to which the election is made are in-scope transactions and must maintain sufficient documentation to allow verification that the taxpayer properly determined its income under the SSA. *See* the documentation requirements in section 4.07, below, which apply for purposes of Treasury Regulation section 1.6662-6.

.03 Application of the SSA to In-Scope Transactions

If it is established that the controlled transaction is an in-scope transaction and that an election has been made, then the appropriate return to the tested party is determined under the SSA by applying the guidance in section 5 of the Report. The following paragraphs clarify the guidance in section 5 of the Report for purposes of applying the SSA for U.S. tax purposes.

(1) Identification of Relevant Matrix Cell

(a) In general, under section 5.1 of the Report, a return-on-sales percentage for the Distributor is determined mechanically by reference to a pricing matrix (derived from the results of a global dataset of comparables), the columns of which correspond to three industry groupings, and the rows of which correspond to various net operating asset intensities and operating expense intensities. *See also* page 12 of the Report for definitions of those terms. For purposes of identifying the applicable column of the matrix under paragraph 47.a. of the Report with respect to an in-scope transaction, if a sale could be categorized under more than one industry grouping, the more specific grouping must be used.

(b) Paragraph 47.b. of the Report requires identification of the applicable row of the matrix by reference to different levels of net operating asset intensity and operating expense intensity. Paragraphs 47.c. and 48 of the Report, in combination, determine the applicable range by first identifying the intersection of the column and row identified under paragraphs 47.a. and 47.b., respectively, and then adding 0.5 to the return-on-sales percentage specified in the relevant matrix cell to determine the upper bound, and subtracting 0.5 from the specified percentage to determine the lower bound of the range. The range so determined applies pursuant to the rules set forth in this section 3.03(1)(b); therefore, the arm's length range and interquartile range concepts set forth in Treasury Regulation section 1.482-1(e) do not apply under the SSA. Subject to sections 5.2 and 5.3 of the Report (as explained further below), if the tested party's reported return-on-sales percentage falls within that range, then no adjustment will be made by the tax administration; if it falls outside that range, then an adjustment to the transfer price may be made by the tax administration as necessary to cause the reported return-on-sales percentage to become equal to the return-on-sales percentage specified in the applicable matrix cell as identified under paragraph 47.c. *See* ¶ 50 of the Report. For example, assume a Distributor elects to apply the SSA and reports income consistent with a return on sales of 3.3% based on its determination that the applicable industry grouping is group 2 under paragraph 47.a. and the applicable factor intensity row is row C under paragraph 47.b., which intersect at the matrix cell that indicates a 3% return on sales and a range of 2.5%-3.5%. However, on audit the tax administration determines that while the applicable factor intensity row is C, the applicable industry grouping is group 1 instead of group 2, and therefore the pricing matrix return is 2.5% with a range under paragraph 47.c. of 2%-3%. Under paragraph 50, the tax administration may make an adjustment to reduce the Distributor's return on sales to the appropriate pricing matrix cell return of 2.5%.

(2) Operating Expense Cross-Check

(a) After the return-on-sales percentage has been determined under section 5.1 of the Report—that is, either the reported percentage (if it was within the range) or the adjusted percentage (if the reported percentage was outside the range)—an operating expense cross-check mechanism, as provided in section 5.2 of the Report, is used to ensure that the application of the SSA under section 5.1 remains appropriate with regard to implied returns on operating expenses. Table 5.2 of the Report provides applicable return-on-operating expense "cap-and-collar" ranges by net operating asset intensity of the tested party to establish an upper and lower bound, respectively, and ensure appropriate results for earnings before interest and taxes ("EBIT")-to-operating expenses ratios. If the equivalent return on operating expenses derived from the return-on-sales percentage determined under section 5.1 falls above the cap rate, paragraph 52.d. of the Report requires adjusting such return-on-sales percentage downward so that the EBIT-to-operating expenses ratio is lowered until it equals the cap rate, to prevent excess profitability from being attributed to lower-risk, routine functions. Conversely, if the equivalent return on operating expenses derived from such return-on-sales percentage falls below the collar rate, an upward adjustment must be made to increase EBIT and, thus, the return-on-sales percentage, so that the EBIT-to-operating expenses ratio is increased to the collar rate to prevent under-remuneration of such activities.

(b) For this purpose, there are two sets of cap rates—alternative cap rates that apply only when the Distributor Country is a qualifying jurisdiction and default cap rates that apply in all other cases. Solely for purposes of the alternative cap rates under section 5.2 of the Report, "qualifying jurisdiction" means a jurisdiction that is classified by the World Bank Group as low income, lower-middle income, or upper-middle income based on the latest available World Bank Group country classifications by income level (hereinafter "section 5.2 qualifying jurisdictions"). *See* section 3.03(4) of this notice.

(c) Building on the prior example in section 3.03(1)(b) of this notice, if the reported return-on-sales percentage of 3.3% was outside the range and, thus, adjusted to 2.5% under section 5.1 of the Report, and if section 5.2 of the Report requires a further adjustment, such further adjustment is made to the 2.5% return-on-sales percentage that was determined after application of the range under section 5.1. (Note: if the reported return-on-sales percentage had been 2.7% and, therefore, had been within the range specified in paragraph 48, then there would have been no adjustment under section 5.1, and the starting point for the adjustment under section 5.2 would have been 2.7%.). In the case of an adjustment under section 5.2, whether the adjusted return-on-sales percentage falls within the range described and applied in section 5.1 is not relevant.

(3) Data Availability Mechanism for Qualifying Jurisdictions

(a) Finally, the return-on-sales percentage determined under section 5.1 of the Report (and then adjusted, if necessary, under section 5.2 of the Report), may require a separate adjustment under the data availability mechanism of section 5.3 of the Report, which provides an additional return for a Distributor located in a qualifying jurisdiction. Solely for purposes of section 5.3 and subject to the following sentence, "qualifying jurisdiction" means jurisdictions (other than members of the European Union) that have both (i) a publicly available long term sovereign credit rating of BBB+ (or equivalent) or lower from a recognized independent credit rating agency, and (ii) fewer than five comparables in the global dataset (hereinafter "section 5.3 qualifying jurisdiction"). In the case of a jurisdiction that does not have a long term sovereign credit rating from a recognized independent credit rating agency but has fewer than five comparables in the global dataset, it will nevertheless be regarded as a section 5.3 qualifying jurisdiction if it is classified by the World Bank Group as low income, lower-middle income, or upper-middle income based on the World Bank Group country classifications by income level. *See* section 3.03(4) of this notice.

(b) Building further on the prior examples in sections 3.03(1)(b) and (2)(c) of this notice, if the Distributor is a section 5.3 qualifying jurisdiction, then an adjustment under paragraph 54 of the Report may be required, using as the starting point the return-on-sales percentage that was determined under section 5.2. (Note: if an adjustment had not been required under section 5.2, then the section 5.3 adjustment would be made using the return-on-sales percentage that was determined under section 5.1 as the starting point.) As under section 5.2 (*see* section 3.03(2)(c), above), whether the return-on-sales percentage as adjusted under section 5.3 falls within the range described and applied in section 5.1 is not relevant.

(4) Qualifying Jurisdictions for Purposes of Sections 5.2 and 5.3 of the Report

The definitions of "section 5.2 qualifying jurisdiction" and "section 5.3 qualifying jurisdiction" are taken from the "Statement on the definitions of qualifying jurisdiction within the meaning of section 5.2 and section 5.3 of the simplified and streamlined approach," which supplemented the Report. The provision of those definitions in that statement was anticipated by the incomplete definitions of "Qualifying jurisdiction(s) within the meaning of Section 5.2" and "Qualifying jurisdiction(s) within the meaning of Section 5.3" that are provided on page 13 of the Report. The lists of section 5.2 qualifying jurisdictions and section 5.3 qualifying jurisdictions will be fixed prospectively based on those definitions, and published and updated every five years on the OECD website.

SECTION 4. CREATION OF A SSA SAFE HARBOR: REQUIREMENTS AND CONSIDERATIONS

.01 Overview

This section 4 describes the proposed rules that the Treasury Department and the IRS intend to issue which would, at a minimum, incorporate the SSA as a safe harbor application of the arm's length standard under the section 482 regulations, as well as the administrative steps that a taxpayer must take to make the election and retain necessary documentation with respect to the SSA. It also describes the extent to which the Commissioner would respect the election for U.S. taxpayers. The Guidelines or the Report may be subject to future revisions and updates. Compliance with this section 4 will be determined based on the guidance in the Report (and as supplemented by the Statements) in effect as of the date of publication of this notice. The Treasury Department and the IRS expect to incorporate updates to the Report in future guidance.

.02 Deemed Satisfaction of the Arm's Length Standard

(1) Subject to the other provisions of this section 4.02, if a valid election to apply the SSA has been made with respect to an in-scope transaction, the Commissioner will consider the SSA to be the best method under the best method rule in Treasury Regulation section 1.482-1(c). Therefore, in such cases, it is not necessary to demonstrate that the SSA is the best method, nor can the Commissioner or an electing taxpayer oppose the application of the SSA on the basis that it is not the best method. In the case of an application of the SSA as described in this section 4.02(1), the SSA will be considered a specified method for purposes of Treasury Regulation section 1.6662-6(d)(2). *See* section 4.04(1) of this notice regarding revisions of the applicable requirements under Treasury Regulation section 1.6662-6(d)(2)(ii)(A) for purposes of the SSA.

(2) Notwithstanding section 4.02(1) of this notice, the SSA will not be treated as the best method if any relevant party (that is, the Distributor, the Related Supplier, or either tax administration) demonstrates that the comparable uncontrolled price method described in Treasury Regula-

tion section 1.482-3(b) using one or more internal comparables can be applied more reliably than the SSA and chooses to apply such method instead of the SSA. *See also* ¶ 42 of the Report.

(3) In any case in which a taxpayer determines a transfer price by reference to the SSA other than as described in section 4.02(1), whether the price so calculated satisfies the arm's length standard would be determined under the section 482 regulations, including the best method rule, and without regard to any guidance in the Report or this notice. The SSA will be considered an unspecified method for that purpose. *See* section 4.04(2) of this notice regarding the applicable requirements under Treasury Regulation section 1.6662-6(d)(3)(ii).

.03 Section 482 Adjustments When the SSA Has Been Applied

(1) The Commissioner may challenge whether a controlled transaction is an in-scope transaction, whether an election to apply the SSA has been made, and whether the income allocation has been properly calculated under the SSA. If the Commissioner determines that a controlled transaction is not an in-scope transaction or otherwise that a valid election was not made, then section 4.02(1) of this notice would not apply. For such transactions, any adjustments would be determined under the otherwise applicable best method analysis set forth in Treasury Regulation section 1.482-1(c).

(2) If the Commissioner determines that a controlled transaction is an in-scope transaction, the exception described in section 4.02(2) does not apply, a valid election to apply the SSA was made, and the transfer price was properly calculated under the SSA, then the Commissioner would not make an adjustment under section 482 with respect to that transaction. If the Commissioner determines that a controlled transaction is an in-scope transaction and that a valid election was made, but the transfer price was not properly calculated under the SSA, then the Commissioner's allocations in such cases under section 482 would be limited to adjusting (i) the amount charged for the in-scope transaction to the amount properly determined under the SSA and (ii) any related amounts properly determined under other rules under section 482.

(3) A taxpayer's valid election to apply the SSA to an in-scope transaction for a taxable year shall constitute consent to the IRS's use of the SSA in calculating any applicable adjustment to such transaction in such taxable year. Thus, a taxpayer that has availed itself of the simplification benefits of the SSA cannot subsequently disavow its reliance on the SSA.

.04 Satisfaction of the Specified and Unspecified Method Requirements under Treasury Regulation Section 1.6662-6(d)(2)(ii)(A) and (3)(ii)

(1) In the case of any controlled transaction to which section 4.02(1) of this notice applies (or to which section 4.02(2) applies where the taxpayer made an election to apply the SSA, but a comparable uncontrolled price method using one or more internal comparables was subsequently properly applied instead), the taxpayer will be deemed to have met the requirements of section 6662(e)(3)(B)(i)(I) and Treasury Regulation section 1.6662-6(d)(2)(ii)(A) if it reasonably concluded that it elected to apply the SSA (including determining that the relevant controlled transaction was an in-scope transaction) as described in the Report and section 3.02 of this notice, and that it correctly applied the mechanics of the SSA as described in the Report and section 3.03 of this notice. Whether the taxpayer's conclusions were reasonable will be determined from all relevant facts and circumstances. The factors relevant to this determination include those described in Treasury Regulation section 1.6662-6(d)(2)(ii)(A) to the extent applicable. In addition, section 4.07 of this notice addresses satisfaction of the documentation requirement under Treasury Regulation section 1.6662-6(d)(2)(iii) in such cases.

(2) In the case of any controlled transaction for which a taxpayer determines a transfer price by reference to the SSA and to which section 4.04(1) of this notice does not apply, the requirements of Treasury Regulation section 1.6662-6(d)(3)(ii)(A) apply without modification.

.05 Scope of Election

Under this notice, a taxpayer elects to apply the SSA on a transaction-by-transaction basis with respect to the taxable year for which the election is filed. A taxpayer that wishes to elect to apply the SSA to the same transaction with respect to future taxable years must file a new election statement as described in section 4.06 of this notice for each taxable year. The Treasury Department and the IRS are considering whether, under proposed regulations, the SSA should include a requirement of consistent treatment such that a taxpayer's election to apply the SSA would be applied in some manner other than on a transaction-by-transaction and taxable year-by-taxable year basis.

.06 Procedure to Elect

A taxpayer elects to apply the SSA by filing with its original return for the taxable year for which the election is made a statement indicating the transaction(s) to which the taxpayer elects to apply the SSA. The statement must be titled "Election to apply the SSA," include a basic description of each transaction, identify the entities participating in each transaction (both name and taxpayer identification number, if applicable), and specify the entities' respective places of incorporation (or jurisdiction of tax residence, if different from place of incorporation). Solely for the purpose of identifying the transactions to which an election applies, transactions may be grouped on the basis of products, product lines, or similar groupings if such grouping basis reasonably enables the Commissioner to distinguish transactions covered by the election from transactions not covered by the election while also avoiding the impracticality of listing each individual transaction that is covered.

.07 Documentation

(1) For controlled transactions with respect to which a valid election to apply the SSA applies, the documentation requirements provided in section 4.07(2) of this notice supplant the requirements contained in Treasury Regulation section 1.6662-6(d)(2)(iii)(B) and (C).

(2) The documentation requirements for taxpayers electing to apply the SSA to in-scope transactions are met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data, any transaction(s) to which it has elected to apply the SSA were in-scope and that the taxpayer properly calculated the return under the SSA, and provides that documentation to the IRS within 30 days of a request for it in connection with an exam-

ination of the taxable year to which the documentation relates. The documentation must be in existence when the return is filed. A minor or inadvertent failure to provide required documents may be excused at the Commissioner's discretion, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known. The taxpayer must maintain books and records that are sufficiently detailed to verify that it has complied with the SSA. Such records shall include:

i. A description of the taxpayer's organizational structure (including an organization chart), including the name(s), employee identification number(s), and U.S. tax classification (where applicable) of all related parties engaged in the transaction(s) to which the SSA is applied;
ii. A copy of the intercompany agreement(s) between the Distributor applying the SSA and its Related Supplier, the terms of which support the statement described in section 4.07(2)iii. of this notice both in form and in substance;
iii. A statement explaining the eligibility of the subject transaction under the SSA scoping criteria set forth in section 3 of the Report;
iv. All underlying data necessary to apply the scoping criterion set forth in paragraph 13.b. of the Report, and the corresponding calculated three-year weighted average operating expense-to-net revenue ratio described in paragraph 24 of the Report;
v. The following financial information, as defined in the Report, for the taxable year for which the return is filed and three preceding taxable years:
    1. Distributor net revenue,
    2. Distributor cost of goods sold,
    3. Distributor net operating assets average balances, including all underlying data, and any applicable adjustments for accounts payable, for each respective taxable year,
    4. Distributor operating expenses,
    5. Distributor EBIT, and
    6. Distributor return on sales;
vi. A statement regarding whether the financial statements of the Distributor required separation of distribution and non-distribution activities as specified in paragraph 14.b of the Report in order to reliably apply the SSA. If a separate basis of the Distributor's financial statements was required, the taxpayer must include an explanation of the methodology used to reliably separate distribution and non-distribution data in the financial statements for net revenues, net operating assets and its components, operating expenses, and earnings before interest and taxes;
vii. Information necessary to apply the pricing matrix and any other applicable provisions of section 5 of the Report, including:
    1. A description of the relevant product(s) distributed,
    2. A statement identifying the industry grouping (1, 2, or 3) selected for each product, including any applicable weighted average calculations,
    3. A statement identifying the factor intensity (A, B, C, D, or E) for each product, including data and calculations for net operating asset intensity and operating expense intensity under section 5.1 of the Report, to the extent such data is not already provided in section 4.07(2)iv. or v. of this notice,
    4. A statement demonstrating application of section 5.2 of the Report and providing conclusions, including all data and calculations required to apply the operating expense cross-check, and
    5. A statement demonstrating application of section 5.3 of the Report, if relevant, and including all data and calculations required to apply the data availability mechanism, if applicable.

Upon examination of an in-scope transaction, the Commissioner may request that the taxpayer submit additional information or translate specific documents within 30 days. The Commissioner may extend this period for good cause.

.08 Competent Authority Considerations

Other jurisdictions may vary both in whether they will respect the application of the SSA as a general matter and, if they do respect it, in their interpretation of the SSA's requirements.[6] Further, although a taxpayer is permitted in the MAP context to assert any argument in support of its position (including an argument based on the SSA), the competent authority of one government cannot support a taxpayer's position based on the SSA if the other government has not implemented the SSA or agreed to accept the application of the SSA in that case. *See generally* section 8 of the Report. Taxpayers should carefully consider section 8 of the Report and potential inconsistencies between jurisdictions' policies with respect to the SSA in deciding (i) whether to elect the SSA under U.S. law or foreign law, (ii) whether to otherwise rely on the SSA, or (iii) the extent and nature of documentation to create and maintain.

SECTION 5. DEFINITIONS

The following definitions apply solely for purposes of this notice.

"Controlled transaction" is defined in Treasury Regulation section 1.482-1(i)(8).

"Distributor" has the meaning provided on page 10 of the Report. Thus, a Distributor is also the tested party referenced in the Report.

The "Distributor Country" is the jurisdiction in which the Distributor is subject to tax with respect to income derived from a qualifying transaction.

An "in-scope transaction" is a qualifying transaction that meets the scoping criteria established in section 3.2 of the

[6] In limited circumstances, the members of the Inclusive Framework have made a political commitment to respect the application of the SSA for in-scope transactions when the Distributor Country is a "covered jurisdiction," as defined and enumerated in the OECD's "Statement on the definition of covered jurisdiction for the Inclusive Framework political commitment on Amount B." See the Introduction to the Report, p.6, fourth paragraph, third sentence. Under this commitment, a member of the Inclusive Framework that is a Related Supplier Country should respect the proper application of the SSA pursuant to the law of the Distributor Country if the Distributor Country is a covered jurisdiction. The intention of the United States to respect the proper application of the SSA by U.S. taxpayers regardless of whether the Distributor Country is a covered jurisdiction, as described in this notice, satisfies the political commitment.

Report, as further elaborated in section 3.3 of the Report. For purposes of the scoping criterion set forth in paragraph 13.b. of the Report, the annual operating expenses incurred by a tested party in a qualifying transaction must be no lower than 3% and must not exceed an upper bound of between 20% and 30% of the tested party's annual net revenues, with such upper bound to be determined by the rules of the Distributor Country.

"Inclusive Framework" refers to the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting.

A "qualifying transaction" is a controlled transaction that is a qualifying transaction within the meaning of section 3.1 of the Report.

A "non-U.S. Distributor" is a Distributor that is subject to tax in a jurisdiction other than the United States with respect to income derived from a qualifying transaction.

A "Related Supplier" is the party to a qualifying transaction that is the associated enterprise as described in paragraph 10 of the Report. Thus, a Related Supplier is the controlled taxpayer (as defined in Treasury Regulation section 1.482-1(i)(5)) in the transaction that is not the Distributor or the tested party referenced in the Report.

The "Related Supplier Country" is the jurisdiction in which the Related Supplier is subject to tax with respect to income derived from a qualifying transaction.

A "U.S. Distributor" is a Distributor that is subject to tax in the United States with respect to income derived from a qualifying transaction.

A "U.S. Related Supplier" is the counterparty to the non-U.S. Distributor with respect to a qualifying transaction.

SECTION 6. APPLICABLITY DATE AND RELIANCE

.01 Applicability Date

It is anticipated that the proposed regulations would provide that rules consistent with the rules described in sections 3 and 4 of this notice apply to taxable years beginning on or after January 1, 2025.

.02 Reliance

Taxpayers may rely on the guidance provided in sections 3 and 4 of this notice, if they apply such guidance in its entirety and in a consistent manner, for taxable years beginning on or after January 1, 2025, and before the proposed regulations are published in the Federal Register. For taxable years beginning on or after January 1, 2025, and before proposed regulations are published in the Federal Register, taxpayers may rely on the text of the SSA for their U.S. tax reporting, as set forth in the Report (and as supplemented by the Statements) if they also apply the rules described in Sections 3 and 4 pursuant to the prior sentence.

SECTION 7. REQUEST FOR COMMENTS

.01 General Overview

The Treasury Department and the IRS request comments from interested persons on this notice. The Treasury Department and the IRS contemplate updating this guidance as appropriate, including by issuing a notice of proposed rulemaking further implementing the safe harbor created by this notice, consistent with Option 1, or implementing a revised version of the SSA that is consistent with Option 2. Comments on all SSA-related topics are welcome and are solicited in particular on the following subjects:

- Whether application of the SSA should be determined solely by an election by taxpayers, or whether other considerations should also be taken into account, such as the ability of the IRS to apply the SSA in the absence of a taxpayer election (as described in section 3.01 of this notice) and whether the availability of the SSA for U.S. taxpayers should depend on whether the SSA has been implemented by the counterparty jurisdiction in order to ensure symmetry of tax treatment;
- Whether the possibility posed in section 4.05 of this notice of requiring elections other than on a transaction-by-transaction and taxable year-by-taxable year basis should be subject to any limitations that serve the interests of simplicity or sound tax administration. Possible limitations on electivity may include requiring that elections apply consistently to all in-scope transactions, to categories of in-scope transactions, to a single in-scope transaction for multiple taxable years, or in a similarly consistent manner.
- the selection of 30% as the upper boundary of the operating expense-to-net revenue ratio scoping criterion pursuant to section 3.2 of the Report.

.02 Procedures for Submitting Comments.

(1) Deadline. Written comments should be submitted by March 7, 2025. Consideration will be given, however, to any written comment submitted after March 7, 2025, if such consideration will not delay the issuance of proposed regulations.

(2) Form and manner. The subject line for the comments should include a reference to Notice 2025-04. All commenters are strongly encouraged to submit comments electronically. However, comments may be submitted in one of two ways:

(a) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2024-0061 in the search field on the regulations.gov homepage to find this notice and submit comments); or

(b) By mail to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2025-04), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044

(3) Publication of comments. The Treasury Department and the IRS will publish for public availability any comments submitted electronically or on paper to its public docket on regulations.gov.

SECTION 8. NO INFERENCE

No inference should be drawn from any provision of this notice concerning any other provision of section 482 or the regulations issued thereunder. *See also* ¶ 4 of the Report. Because the design choices reflected in the SSA are the result of a negotiated construction of a simplification measure that is intended to be applied across a relatively broad range of fact patterns, it should not be inferred that any single design choice or combination thereof in the SSA implies the proper design of a best method for any transaction under the rest of the section 482 regulations regardless of whether it is an in-scope transaction. *See also* ¶ 43 of the Report. The mere fact that an activity does not qualify for the SSA should not be interpreted to mean that such activity generates lower or higher returns than is permissible under the SSA or that the returns provided by the SSA for in-scope taxpayers represent a floor or a ceiling for returns to distribution activities in general. *See also* ¶ 9 of the Report.

SECTION 9. PAPERWORK REDUCTION ACT

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) (PRA) generally requires that a federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. 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 OMB. The collections of information in this notice are in sections 4.06 and 4.07. This information is required to enable the IRS to verify that a taxpayer is reporting the correct amount of taxable income. The collections of information will be used by the IRS for tax compliance purposes. The likely respondents are business and other for-profit institutions.

This notice includes a reporting requirement to provide the IRS with a statement indicating the transactions to which the taxpayer elects to apply the SSA, as described in section 4.06 of this notice. The recordkeeping requirements include that taxpayers keep books of account and records that are adequate to permit verification that the controlled transactions are within scope, that the SSA has been properly applied, and that a taxpayer is reporting the correct amount of taxable income. These collection requirements supplement the existing collection requirements within Treasury Regulation section 1.6662-6 (referenced in section 4.07 of this notice), which are included in the OMB Control Number 1545-0123 for business filers.

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

SECTION 10. DRAFTING AND CONTACT INFORMATION

The principal authors of this notice are Lorraine Saxton Rodriguez and Robert Z. Kelley of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Lorraine Saxton Rodriguez or Robert Z. Kelley at (202) 317-6939 (not a toll-free number).

2025 Standard Mileage Rates

Notice 2025-5

SECTION 1. PURPOSE

This notice provides the optional 2025 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate (FAVR) plan. Additionally, this notice provides the maximum fair market value (FMV) of employer-provided automobiles first made available to employees for personal use in calendar year 2025 for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) or the vehicle cents-per-mile valuation rule in § 1.61-21(e).[1]

SECTION 2. BACKGROUND

Rev. Proc. 2019-46, 2019-49 I.R.B. 1301, provides rules for computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes, and for substantiating, under § 274(d) and § 1.274-5, the amount of ordinary and necessary business expenses of local transportation or travel away from home. Taxpayers using the standard mileage rates must comply with Rev. Proc. 2019-46. However, a taxpayer is not required to use the substantiation methods described in Rev. Proc. 2019-46, but instead may substantiate using actual allowable expense amounts if the taxpayer maintains adequate records or other sufficient evidence.

An independent contractor conducts an annual study for the Internal Revenue Service of the fixed and variable costs of operating an automobile to determine the standard mileage rates for business, medical, and moving use reflected in this notice. The standard mileage rate for charitable use is set by § 170(i).

Longstanding regulations under § 61 provide special valuation rules for employer-provided automobiles. The amount that must be included in the employee's income and wages for the personal use of an employer-provided automobile generally is determined by reference to the automobile's FMV. If an employer chooses to use a special valuation rule, the special value is treated as the FMV of the benefit for income tax and employment tax purposes. Section 1.61-21(b)(4). Two such special valuation rules, the fleet-average valuation rule and the vehicle cents-per-mile valuation rule, are set forth in § 1.61-21(d)(5)(v) and § 1.61-21(e), respectively. These two special valuation rules are subject to limitations, including that they may be used only in connection with automobiles having values that do not exceed a maximum amount set forth in the regulations.

SECTION 3. STANDARD MILEAGE RATES

The standard mileage rate for transportation or travel expenses for 2025 is 70 cents per mile for all miles of business use (business standard mileage rate). See section 4 of Rev. Proc. 2019-46. However, § 11045 of Public Law 115-97, 131. Stat. 2054 (December 22, 2017), com-

[1] Unless otherwise specified, all "section" or "§" references are to sections of the Internal Revenue Code (Code) or the Income Tax Regulations (26 CFR part 1).

monly known as the Tax Cuts and Jobs Act (TCJA) suspends all miscellaneous itemized deductions that are subject to the two-percent of adjusted gross income floor under § 67, including unreimbursed employee travel expenses, for taxable years beginning after December 31, 2017, and before January 1, 2026. Thus, the business standard mileage rate provided in this notice cannot be used to claim an itemized deduction for unreimbursed employee travel expenses during the suspension. Notwithstanding the foregoing suspension of miscellaneous itemized deductions, deductions for expenses that are deductible in determining adjusted gross income are not suspended. For example, members of a reserve component of the Armed Forces of the United States (Armed Forces), state or local government officials paid in whole or in part on a fee basis, and certain performing artists are entitled to deduct unreimbursed employee travel expenses as an adjustment to total income on line 12 of Schedule 1 of Form 1040 (2024), *U.S. Individual Income Tax Return*, not as an itemized deduction on Schedule A of Form 1040 (2024), and therefore may continue to use the business standard mileage rate.

The standard mileage rate is 14 cents per mile for use of an automobile in rendering gratuitous services to a charitable organization under § 170. See section 5 of Rev. Proc. 2019-46.

The standard mileage rate for 2025 is unchanged from 2024 at 21 cents per mile for use of an automobile: (1) for medical care described in § 213; or (2) as part of a move for which the expenses are deductible under § 217(g). See section 5 of Rev. Proc. 2019-46. Section 11049 of the TCJA suspends the deduction for moving expenses for taxable years beginning after December 31, 2017, and before January 1, 2026. However, the suspension does not apply to members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. Thus, except for taxpayers to whom § 217(g) applies, the standard mileage rate provided in this notice is not applicable for the use of an automobile as part of a move occurring during the suspension.

SECTION 4. BASIS REDUCTION AMOUNT

For automobiles a taxpayer uses for business purposes, the portion of the business standard mileage rate treated as depreciation is 26 cents per mile for 2021, 26 cents per mile for 2022, 28 cents per mile for 2023, and 30 cents per mile for 2024, and 33 cents per mile for 2025. See section 4.04 of Rev. Proc. 2019-46.

SECTION 5. MAXIMUM STANDARD AUTOMOBILE COST

For purposes of computing the allowance under a FAVR plan, the standard automobile cost may not exceed $61,200 for automobiles (including trucks and vans). See section 6.02(6) of Rev. Proc. 2019-46.

SECTION 6. MAXIMUM VALUE OF EMPLOYER-PROVIDED AUTOMOBILES

For purposes of the fleet-average valuation rule in § 1.61-21(d)(5)(v) and the vehicle cents-per-mile valuation rule in § 1.61-21(e), the maximum FMV of automobiles (including trucks and vans) first made available to employees in calendar year 2025 is $61,200**.**

SECTION 7. EFFECTIVE DATE

This notice is effective for: (1) deductible transportation expenses paid or incurred on or after January 1, 2025; (2) mileage allowances or reimbursements paid to a charitable volunteer or a member of the Armed Forces to whom § 217(g) applies: (a) on or after January 1, 2025, and (b) for transportation expenses the charitable volunteer or such member of the Armed Forces pays or incurs on or after January 1, 2025; and (3) for purposes of the maximum FMV of employer-provided automobiles for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) or the vehicle cents-per-mile rule in § 1.61-21(e), automobiles first made available to employees for personal use on or after January 1, 2025.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Notice 2024-08 is superseded.

DRAFTING INFORMATION

The principal author of this notice is Christian Lagorio of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information on this notice regarding the use of an employee-provided automobile, contact Mr. Lagorio at (202) 317-7005 (not a toll-free number). For further information on this notice regarding the use of an employer-provided automobile, contact Stephanie Caden of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes), at (202) 317-4774 (not a toll-free number).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.

(Also, Part 1, §§ 174, 446; 1.446-1.)

Rev. Proc. 2025-8

SECTION 1. PURPOSE

This revenue procedure modifies section 7 of Rev. Proc. 2024-23, 2024-23 I.R.B. 1334, to modify the procedures under § 446 of the Internal Revenue Code (Code)[1] and § 1.446-1(e) for obtaining automatic consent of the Commissioner of Internal Revenue (Commissioner) to change methods of accounting for expenditures paid or incurred in taxable years beginning after December 31, 2021, to comply with § 174 or to rely on interim guidance provided in sections 3 through 7 of Notice 2023-63, 2023-39 I.R.B. 919, as modified by Notice 2024-12, 2024-5 I.R.B. 616. References in this revenue procedure to "former § 174" refer to that section as in effect for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022, that is, prior to the effective date of the amendments made to § 174

[1] Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

by § 13206(a) of Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). References to "§ 174" in this revenue procedure refer to § 174 as amended by the TCJA.

SECTION 2. BACKGROUND

.01 *Treatment of research and experimental expenditures under former § 174*.

Former § 174 allowed taxpayers to deduct research or experimental expenditures paid or incurred in connection with a trade or business as current expenses, or alternatively, charge such expenditures to capital account and amortize them ratably over a period of not less than 60 months.

.02 *Treatment of SRE expenditures under § 174*.

(1) Section 13206(a) of the TCJA amended former § 174. For amounts paid or incurred in taxable years beginning after December 31, 2021, that meet the definition of specified research or experimental (SRE) expenditures under § 174(b), § 174(a)(1) disallows deductions for such amounts, except as provided in § 174(a)(2). Section 174(a)(2) requires taxpayers to charge SRE expenditures to capital account and allows amortization deductions of such capitalized expenditures ratably over a 5-year period in the case of SRE expenditures attributable to domestic research, or a 15-year period in the case of SRE expenditures attributable to foreign research, beginning with the midpoint of the taxable year in which such expenditures are paid or incurred. For additional background on former § 174 and the TCJA amendments to former § 174, see section 2 of Notice 2023-63.

(2) Section 13206(b) of the TCJA requires taxpayers to treat the amendments made by § 13206(a) of the TCJA as a change in method of accounting for purposes of § 481 that is (i) initiated by the taxpayer, (ii) made with the consent of the Secretary of the Treasury or her delegate, and (iii) applied on a cut-off basis to SRE expenditures paid or incurred in taxable years beginning after December 31, 2021. Thus, no adjustments under § 481(a) are required or permitted with respect to research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022.

.03 *Procedural guidance under Rev. Proc. 2023-11*.

On December 29, 2022, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) issued Rev. Proc. 2023-11, 2023-3 I.R.B. 417, modifying and superseding Rev. Proc. 2023-8, 2023-3 I.R.B. 407, to provide procedures to obtain automatic consent to change methods of accounting for SRE expenditures to comply with § 174. The change in method of accounting provided by Rev. Proc. 2023-11 was subsequently included in section 7.02 of Rev. Proc. 2023-24, 2023-28 I.R.B. 1207.

.04 *Interim guidance under Notice 2023-63, as modified by Notice 2024-12*.

Notice 2023-63 was issued on September 8, 2023, to announce that the Treasury Department and the IRS intend to issue proposed regulations addressing (1) the capitalization and amortization of SRE expenditures under § 174, (2) the treatment of SRE expenditures under § 460, and (3) the application of § 482 to cost sharing arrangements involving SRE expenditures. Sections 3 through 9 of Notice 2023-63 provide interim guidance regarding issues intended to be addressed by forthcoming proposed regulations. Notice 2024-12 was issued on December 22, 2023, to provide additional interim guidance to clarify and modify Notice 2023-63.

.05 *Procedural guidance under Rev. Proc. 2024-9*.

Revenue Procedure 2024-9, 2024-5 I.R.B. 628, was issued on December 22, 2023, to provide procedures for taxpayers to obtain automatic consent to change methods of accounting for expenditures paid or incurred in taxable years beginning after December 31, 2021, to comply with § 174 or to rely on interim guidance under §§ 174 and 460 provided in Notice 2023-63, as modified by Notice 2024-12. The change in method of accounting for § 174 provided in section 3 of Rev. Proc. 2024-9 modified section 7.02 of Rev. Proc. 2023-24. Rev. Proc. 2023-24 was subsequently superseded in part by Rev. Proc. 2024-23. Rev. Proc. 2024-23 renumbered section 7.02 as section 7.01 and removed former section 7.01 as obsolete.

.06 *Procedural guidance under Rev. Proc. 2024-34*.

(1) Revenue Procedure 2024-34, 2024-38 I.R.B. 604, was issued on August 29, 2024, to provide procedures for taxpayers to obtain automatic consent to change methods of accounting for expenditures paid or incurred in taxable years beginning after December 31, 2021, to comply with § 174 or to rely on interim guidance provided in sections 3 through 7 of Notice 2023-63, as modified by Notice 2024-12. Section 3 of Rev. Proc. 2024-34 modified section 7.01(5) and (6) of Rev. Proc. 2024-23.

(2) Section 7.01(5)(a) of Rev. Proc. 2024-23, as modified by section 3.01 of Rev. Proc. 2024-34, waives the eligibility rules in section 5.01(1)(d) (regarding changes made in the final year of a trade or business) and section 5.01(1)(f) (regarding changes made in the previous five years for the same item) of Rev. Proc. 2015-13 for a change described in section 7.01(1)(a) of Rev. Proc. 2024-23 made by a taxpayer for any taxable year beginning in 2022 or 2023.

(3) Section 7.01(5)(b) of Rev. Proc. 2024-23, as modified by section 3.01 of Rev. Proc. 2024-34, provides that a taxpayer may make a change described in section 7.01(1)(a) of Rev. Proc. 2024-23 for a taxable year beginning in 2022 or 2023, regardless of whether the taxpayer made a change for the same item for any previous taxable year beginning in 2022 or 2023.

(4) Section 7.01(6) of Rev. Proc. 2024-23, as modified by section 3.01 of Rev. Proc. 2024-34, provides the following: First, a taxpayer does not receive audit protection under section 8.01 of Rev. Proc. 2015-13 for a change under section 7.01(1)(a) of Rev. Proc. 2024-23 with respect to expenditures paid or incurred in taxable years beginning on or before December 31, 2021. Second, a taxpayer does not receive audit protection under section 8.01 of Rev. Proc. 2015-13 for a change under section 7.01(1)(a) of Rev. Proc. 2024-23 made for any taxable year beginning in 2022 or 2023 (other than the first taxable year beginning after December 31, 2021), with respect to expenditures paid or incurred in the first taxable year beginning after December 31, 2021, if the taxpayer did not change its method of accounting under section 7.01(1)(a) in an effort to comply with § 174 for the first

taxable year beginning after December 31, 2021. See section 8.02(2) of Rev. Proc. 2015-13.

.07 *Changing methods of accounting under § 446(e)*.

(1) Except as otherwise expressly provided in the Code and the regulations thereunder, § 446(e) and § 1.446-1(e)(2) require a taxpayer to secure the consent of the Commissioner before changing a method of accounting for Federal income tax purposes. Section 1.446-1(e)(3)(i) states, in part, that except as otherwise provided under the authority of § 1.446-1(e)(3)(ii), to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer generally must file a Form 3115, *Application for Change in Accounting Method*, with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures will prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted.

(2) Rev. Proc. 2015-13, 2015-5 I.R.B. 419, as clarified and modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067, and as modified by Rev. Proc. 2021-34, 2021-35 I.R.B. 337, Rev. Proc. 2021-26, 2021-22 I.R.B. 1163, Rev. Proc. 2017-59, 2017-48 I.R.B. 543, and section 17.02(b) and (c) of Rev. Proc. 2016-1, 2016-1 I.R.B. 1, sets forth the general administrative procedures by which a taxpayer may obtain the automatic consent of the Commissioner to change a method of accounting described in the *List of Automatic Changes*. Rev. Proc. 2024-23 contains the current *List of Automatic Changes*.

(3) A change in a taxpayer's treatment of expenditures paid or incurred in taxable years beginning after December 31, 2021, to comply with § 174 or to rely on the interim guidance in sections 3 through 7 of Notice 2023-63 is generally a change in method of accounting to which §§ 446(e) and 481, and the corresponding regulations, apply. A taxpayer that changes its method of accounting to comply with § 174 or to rely on the interim guidance in sections 3 through 7 of Notice 2023-63 must use the accounting method change procedures in Rev. Proc. 2015-13 or its successor. Section 3 of this revenue procedure modifies the eligibility rules in section 7.01 of Rev. Proc. 2024-23 to allow taxpayers to obtain automatic consent to change their method of accounting to comply with § 174 or to rely on the interim guidance provided in sections 3 through 7 of Notice 2023-63 for taxable years beginning after December 31, 2021.

(4) Specifically, the Treasury Department and the IRS are aware that certain taxpayers may not be eligible to file automatic changes in methods of accounting under section 7.01 of Rev. Proc. 2024-23 for a taxable year beginning in 2024. This is because the waiver of the eligibility rules in section 5.01(1)(d) and (f) of Rev. Proc. 2015-13 applies only to a change described in section 7.01(1)(a) of Rev. Proc. 2024-23 made by a taxpayer for any taxable year beginning in 2022 or 2023. Therefore, the procedures in section 3 of this revenue procedure modify the eligibility rules in section 7.01(5)(a) of Rev. Proc. 2024-23 to provide that the eligibility rules in section 5.01(1)(d) and (f) of Rev. Proc. 2015-13 do not apply to a change described in section 7.01(1)(a) of Rev. Proc. 2024-23 made by a taxpayer for any taxable year beginning in 2022, 2023, or 2024. The procedures in section 3 of this revenue procedure also modify the rules for changes made in successive taxable years in section 7.01(5)(b) of Rev. Proc. 2024-23 to provide that a taxpayer may make a change described in section 7.01(1)(a) of Rev. Proc. 2024-23 for a taxable year beginning in 2022, 2023, or 2024, regardless of whether the taxpayer made a change for the same item for any previous taxable year beginning in 2022, 2023, or 2024.

SECTION 3. MODIFICATIONS TO REV. PROC. 2024-23

.01 *Modification of section 7.01(5) of Rev. Proc. 2024-23*. Section 7.01(5) of Rev. Proc. 2024-23, is modified to read as follows:

(5) *Certain eligibility rules inapplicable*.

(a) *In general*. The eligibility rules in section 5.01(1)(d) and (f) of Rev. Proc. 2015-13, 2015-5 I.R.B. 419, do not apply to a change described in section 7.01(1)(a) of this revenue procedure made by a taxpayer for any taxable year beginning in 2022, 2023, or 2024.

(b) *Changes made in successive taxable years*. A taxpayer may make a change described in section 7.01(1)(a) of this revenue procedure for a taxable year beginning in 2022, 2023, or 2024, regardless of whether the taxpayer made a change for the same item for any previous taxable year beginning in 2022, 2023, or 2024.

SECTION 4. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies section 7.01 of Rev. Proc. 2024-23.

SECTION 5. EFFECTIVE DATE

.01 *In general*. Except as otherwise provided under this section 5, this revenue procedure is effective for Forms 3115 filed on or after December 17, 2024.

.02 *Limited time period to convert a Form 3115 filed under the non-automatic change procedures in Rev. Proc. 2015-13*.

(1) If, before December 17, 2024, a taxpayer properly filed a Form 3115 under the non-automatic change procedures in Rev. Proc. 2015-13 requesting the Commissioner's consent for a change in method of accounting described in section 7.01(1)(a) of Rev. Proc. 2024-23, and the Form 3115 is pending with the national office on December 17, 2024, the taxpayer may choose to make the change in method of accounting under the automatic change procedures in Rev. Proc. 2015-13 if the taxpayer is now eligible to use the automatic accounting method change described in section 7.01(1)(a) of Rev. Proc. 2024-23 as a result of the modifications made by this Rev. Proc. 2025-8 (and is otherwise eligible to use section 7.01(1)(a) of Rev. Proc. 2024-23 and the automatic change procedures in Rev. Proc. 2015-13). The taxpayer must notify the national office contact person (if unknown, fax the notification to 855-574-9031 or send the notification to the attention of Control Clerk, CC:ITA, Room 4512 at the address specified in section 9.08(6) of Rev. Proc. 2024-1, 2024-1 I.R.B. 1 (or its successor)) for the Form 3115 of the taxpayer's intent to

make the change in method of accounting under the automatic change procedures in Rev. Proc. 2015-13 before the later of (a) January 17, 2025, or (b) the issuance of a letter ruling granting or denying consent for the change. The notification should indicate that the taxpayer chooses to convert the Form 3115 to the automatic change procedures in Rev. Proc. 2015-13. If the taxpayer timely notifies the national office that it chooses to convert the Form 3115 to the automatic change procedures in Rev. Proc. 2015-13, the national office will send a letter to the taxpayer acknowledging its request and will return the user fee submitted with the Form 3115.

(2) A taxpayer converting a Form 3115 to the automatic change procedures in Rev. Proc. 2015-13 for a change in method of accounting described in this revenue procedure must resubmit a Form 3115 that conforms to the automatic change procedures, with a copy of the national office letter sent acknowledging the taxpayer's request attached, to the IRS in Ogden, UT by the earlier of (a) the 30th calendar day after the date of the national office's letter acknowledging the taxpayer's request, or (b) the date the taxpayer is required to file the duplicate copy of the Form 3115 under section 6.03(1)(a)(i)(B) of Rev. Proc. 2015-13. See section 6.03(3) of Rev. Proc. 2015-13 regarding additional required copies of Form 3115.

(3) For purposes of the eligibility rules in section 5 of Rev. Proc. 2015-13, the duplicate copy of the timely resubmitted Form 3115 will be considered filed as of the date the taxpayer originally filed the converted Form 3115 under the non-automatic change procedures in Rev. Proc. 2015-13. This section 5.02 does not extend the date the taxpayer must file the original (converted) Form 3115 under section 6.03(1)(a)(i)(A) of Rev. Proc. 2015-13.

(4) A Form 3115 filed under the non-automatic change procedures in Rev. Proc. 2015-13 before December 17, 2024, for a change in method of accounting described in this revenue procedure, will be disregarded for purposes of the prior five-year change rules in section 5.04 and 5.05 of Rev. Proc. 2015-13 if the taxpayer converts the Form 3115 pursuant to this section 5.02.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget under OMB control numbers 1545-0074 for individual filers, 1545-0123 for business filers, and 1545-0047 for tax-exempt filers, in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507(d)). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. The collection of information in this revenue procedure is in section 5.02 of this revenue procedure. This information is necessary and will be used to determine whether the taxpayer properly changed to a permitted method of accounting. The collection of information is required for the taxpayer to obtain consent to change its method of accounting.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Jeremy Pfeifer of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, please contact Mr. Pfeifer at (202) 317-4176 (not a toll-free number).

Part IV

Announcement of Disciplinary Sanctions From the Office of Professional Responsibility

Announcement 2025-1

The Office of Professional Responsibility (OPR) announces recent disciplinary sanctions involving attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, appraisers, and unenrolled/unlicensed return preparers (individuals who are not enrolled to practice and are not licensed as attorneys or certified public accountants). Licensed or enrolled practitioners are subject to the regulations governing practice before the Internal Revenue Service (IRS), which are set out in Title 31, Code of Federal Regulations, Subtitle A, Part 10, and which are released as Treasury Department Circular No. 230. The regulations prescribe the duties and restrictions relating to such practice and prescribe the disciplinary sanctions for violating the regulations. Unenrolled/unlicensed return preparers are subject to Revenue Procedure 81-38 and superseding guidance in Revenue Procedure 2014-42, which govern a preparer's eligibility to represent taxpayers before the IRS in examinations of tax returns the preparer both prepared for the taxpayer and signed as the preparer. Additionally, unenrolled/unlicensed return preparers who voluntarily participate in the Annual Filing Season Program under Revenue Procedure 2014-42 agree to be subject to the duties and restrictions in Circular 230, including the restrictions on incompetent or disreputable conduct.

The disciplinary sanctions to be imposed for violation of the applicable standards are:

Disbarred from practice before the IRS—An individual who is disbarred is not eligible to practice before the IRS as defined at 31 C.F.R. § 10.2(a)(4) for a minimum period of five (5) years.

Suspended from practice before the IRS—An individual who is suspended is not eligible to practice before the IRS as defined at 31 C.F.R. § 10.2(a)(4) during the term of the suspension.

Censured in practice before the IRS—Censure is a public reprimand. Unlike disbarment or suspension, censure does not affect an individual's eligibility to practice before the IRS, but OPR may subject the individual's future practice rights to conditions designed to promote high standards of conduct.

Monetary penalty—A monetary penalty may be imposed on an individual who engages in conduct subject to sanction, or on an employer, firm, or entity if the individual was acting on its behalf and it knew, or reasonably should have known, of the individual's conduct.

Disqualification of appraiser—An appraiser who is disqualified is barred from presenting evidence or testimony in any administrative proceeding before the Department of the Treasury or the IRS.

Ineligible for limited practice—An unenrolled/unlicensed return preparer who fails to comply with the requirements in Revenue Procedure 81-38 or to comply with Circular 230 as required by Revenue Procedure 2014-42 may be determined ineligible to engage in limited practice as a representative of any taxpayer.

Under the regulations, individuals subject to Circular 230 may not assist, or accept assistance from, individuals who are suspended or disbarred with respect to matters constituting practice (*i.e.*, representation) before the IRS, and they may not aid or abet suspended or disbarred individuals to practice before the IRS.

Disciplinary sanctions are described in these terms:

Disbarred by decision, Suspended by decision, Censured by decision, Monetary penalty imposed by decision, and Disqualified after hearing—An administrative law judge (ALJ) issued a decision imposing one of these sanctions after the ALJ either (1) granted the government's summary judgment motion or (2) conducted an evidentiary hearing upon OPR's complaint alleging violation of the regulations. After 30 days from the issuance of the decision, in the absence of an appeal, the ALJ's decision becomes the final agency decision.

Disbarred by default decision, Suspended by default decision, Censured by default decision, Monetary penalty imposed by default decision, and Disqualified by default decision—An ALJ, after finding that no answer to OPR's complaint was filed, granted OPR's motion for a default judgment and issued a decision imposing one of these sanctions.

Disbarment by decision on appeal, Suspended by decision on appeal, Censured by decision on appeal, Monetary penalty imposed by decision on appeal, and Disqualified by decision on appeal—The decision of the ALJ was appealed to the agency appeal authority, acting as the delegate of the Secretary of the Treasury, and the appeal authority issued a decision imposing one of these sanctions.

Disbarred by consent, Suspended by consent, Censured by consent, Monetary penalty imposed by consent, and Disqualified by consent—In lieu of a disciplinary proceeding being instituted or continued, an individual offered a consent to one of these sanctions and OPR accepted the offer. Typically, an offer of consent will provide for: suspension for an indefinite term; conditions that the individual must observe during the suspension; and the individual's opportunity, after a stated number of months, to file with OPR a petition for reinstatement affirming compliance with the terms of the consent and affirming current fitness and eligibility to practice (*i.e.*, an active professional license or active enrollment status, with no intervening violations of the regulations).

Suspended indefinitely by decision in expedited proceeding, Suspended indefinitely by default decision in expedited proceeding, Suspended by consent in expedited proceeding—OPR instituted an expedited proceeding for suspension (based on certain limited grounds, including loss of a professional license for cause, and criminal convictions).

Determined ineligible for limited practice—-There has been a final determination that an unenrolled/unlicensed return preparer is not eligible for limited representation of any taxpayer because the preparer violated standards of conduct or failed to comply with any of the requirements to act as a representative.

A practitioner who has been disbarred or suspended under 31 C.F.R. § 10.60, or suspended under § 10.82, or a disqualified appraiser may petition for reinstatement before the IRS after the expiration of 5 years following such disbarment, suspension, or disqualification (or immediately following the expiration of the suspension or disqualification period if shorter than 5 years). Reinstatement will not be granted unless the IRS is satisfied that the petitioner is not likely to engage thereafter in conduct contrary to Circular 230, and that granting such reinstatement would not be contrary to the public interest.

Reinstatement decisions are published at the individual's request, and described in these terms:

Reinstated to practice before the IRS—-The individual's petition for reinstatement has been granted. The agent, and eligible to practice before the IRS, or in the case of an appraiser, the individual is no longer disqualified.

Reinstated to engage in limited practice before the IRS—-The individual's petition for reinstatement has been granted. The individual is an unenrolled/unlicensed return preparer and eligible to engage in limited practice before the IRS, subject to requirements the IRS has prescribed for limited practice by tax return preparers.

OPR has authority to disclose the grounds for disciplinary sanctions in these situations: (1) an ALJ or the Secretary's delegate on appeal has issued a final decision; (2) the individual has settled a disciplinary case by signing OPR's "consent to sanction" agreement admitting to one or more violations of the regulations and consenting to the disclosure of the admitted violations (for example, failure to file Federal income tax returns, lack of due diligence, conflict of interest, etc.); (3) OPR has issued a decision in an expedited proceeding for indefinite suspension; or (4) OPR has made a final determination (including any decision on appeal) that an unenrolled/unlicensed return preparer is ineligible to represent any taxpayer before the IRS.

Announcements of disciplinary sanctions appear in the Internal Revenue Bulletin at the earliest practicable date. The sanctions announced below are alphabetized first by state and second by the last names of the sanctioned individuals.

City & State	Name	Professional Designation	Disciplinary Sanction	Effective Date(s)
California				
	Iheke, Chuks L., see Texas			
Florida				
	Lapensohn, Howard C., see Pennsylvania			
Georgia				
Milton	Tarantino, Peter J.	CPA	Suspended by decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from July 22, 2024
Iowa				
Hampton	Wiechmann, Jr., Daniel F.	Attorney	Suspended by default decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from July 18, 2024
Missouri				
St. Louis	Van De Riet, Richard L.	CPA	Suspended by default decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from August 20, 2024
New York				
White Plains	Savignano, John J.	CPA		Reinstated to practice before the IRS, effective July 17, 2024
New City	Silverman, George J.	CPA	Suspended by decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from August 14, 2024

City & State	Name	Professional Designation	Disciplinary Sanction	Effective Date(s)
North Carolina				
Shelby	Roberts II, Walter "Terry" D.	Appraiser	Disqualified by consent for admitted violations of 31 C.F.R. §§ 10.51(a)(2) and 10.51(a)(4)	Indefinite from August 2, 2024
Pennsylvania				
Philadelphia	Lapensohn, Howard C.	CPA	Suspended by default decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from July 22, 2024
Tennessee				
Signal Mountain	Fulton, David J.	Attorney	Suspended by default decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from August 8, 2024
Texas				
Round Rock	Iheke, Chuks L.	CPA	Suspended by decision in expedited proceeding under 31 C.F.R. § 10.82(b)	Indefinite from August 21, 2024

United States' Notification of Partial Suspension, by Mutual Agreement, of 1973 Tax Convention with the USSR as it relates to Belarus

Announcement 2025-5

The U.S. Department of the Treasury announced that the United States provided formal notice to the Republic of Belarus on December 17, 2024, to confirm the suspension of the operation of paragraph 1, subparagraph (g), of Article III of the Convention between the United States of America and the Union of Soviet Socialist Republics on Matters of Taxation, with related letters, signed at Washington June 20, 1973 (the "Convention"), as it relates to Belarus, by mutual agreement. See Press Release, United States' Notification of Partial Suspension, by Mutual Agreement, of 1973 Tax Convention with the USSR as it relates to Belarus (December 17, 2024), https://home.treasury.gov/news/press-releases/jy2754.

The suspension is effective December 17, 2024, until December 31, 2026, or earlier if mutually determined by the two governments. This action responds to notification by the Republic of Belarus on March 21, 2024, of its desire to suspend paragraph 1, subparagraph (g), of Article III of the Convention until December 31, 2026.

For further information regarding this announcement contact the Office of Associate Chief Counsel (International) at (202) 317-3800 (not a toll-free number).

Notice of Proposed Rulemaking

Accounting for Disregarded Transactions Between a Qualified Business Unit and Its Owner

REG-117213-24

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the determination of taxable income or loss and foreign currency gain or loss with respect to a qualified business unit. The proposed regulations include an election that is intended to reduce the compliance burden of accounting for certain disregarded transactions between a qualified business unit and its owner. This document also includes a request for comments relating to the treatment of partnerships and controlled foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by March 11, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG-117213-24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comments submitted to the IRS's public docket. Send paper submissions to: CC:PA:01:PR (REG-117213-24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Adam G. Province at (865) 329-4546; concerning submissions of comments, requests for a public hearing, and access to a public hearing, Publications and Regulations Section at (202) 317-6901 (not toll-free numbers) or by e-mail to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

This document contains proposed additions and amendments to 26 CFR part 1 (Income Tax Regulations) addressing the application of section 987 of the Internal Revenue Code (Code) and related provisions (the "proposed regulations"). The additions and amendments are issued under sections 987 and 989, pursuant to the express delegations of authority provided under those sections. The express delegations relied upon are referenced in the Background section of this preamble. The proposed regulations are also issued under the express delegation of authority under section 7805 of the Code.

Background

This document contains proposed regulations under section 987 of the Code. Section 987 applies to any taxpayer that has a qualified business unit (QBU) with a functional currency other than the dollar. Section 987(1) and (2) provide rules for determining and translating taxable income or loss ("section 987 taxable income or loss") with respect to the QBU. In addition, foreign currency gain or loss must be determined under section 987(3) ("section 987 gain or loss"), which requires proper adjustments (as prescribed by the Secretary) for transfers of property between QBUs of the taxpayer having different functional currencies.

Sections 987 and 989 provide several explicit grants of regulatory authority. The statute does not specify how the proper adjustments should be made under section 987(3), but instead directs the Secretary to prescribe the proper adjustments needed to determine the taxable income of the owner of a section 987 QBU. Section 989(c) directs the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subpart."[1] The grants of authority in section 989(c) include regulations providing for the appropriate treatment of related party transactions (including transactions between QBUs of the same taxpayer). Section 989(c)(5).

Concurrently with the publication of these proposed regulations, the Treasury Department and the IRS are publishing in the rules and regulations section of this edition of the **Federal Register** (RIN 1545-BO07) final regulations under sections 861, 985, 987 through 989, and 1502 of the Code (the "final regulations"). On November 14, 2023, the Treasury Department and the IRS published proposed regulations (REG-132422-17) under those same sections of the Code (the "2023 proposed regulations") in the **Federal Register** (88 FR 78134). The comments received in response to the 2023 proposed regulations, and the revisions made in response to those comments, are summarized in the Summary of Comments and Explanation of Revisions in the preamble to the final regulations. In response to certain comments, the Treasury Department and the IRS are publishing this notice of proposed rulemaking to provide additional proposed rules under section 987 and to request comments relating to the application of section 987 to partnerships and controlled foreign corporations ("CFCs").

Explanation of Provisions

The proposed regulations provide an election under which, in certain cases, taxpayers can translate a group of frequently recurring transfers between a section 987 QBU and its owner using the yearly average exchange rate (rather than the spot rate applicable on the date of each transfer). The proposed regulations also would simplify the computation of unrecognized section 987 gain or loss under § 1.987-4 for taxpayers that make this election.

I. *Rules of the Final Regulations Relating to Disregarded Transactions*

A. *Accounting for disregarded transactions between a section 987 QBU and its owner*

Under the final regulations, an asset is treated as transferred to a section 987 QBU from its owner if, because of a disregarded transaction, the asset is reflected on the books and records of the section 987 QBU. *See* § 1.987-2(c)(2)(i). Similarly, an asset is treated as transferred from a section 987 QBU to its owner if, because of a disregarded transaction, the asset ceases to be reflected on the books and records of the section 987 QBU. Thus, for example, if a section 987 QBU purchases inventory from its owner (or another eligible QBU of its owner) in a disregarded transaction, the section 987 QBU is treated as distributing cash to its owner, and the owner is treated as contributing the inventory to the section 987 QBU. Disregarded transactions, however, do not give rise to items of income, gain, deduction, or loss that are taken into account in determining section 987 taxable income or loss under § 1.987-3. *See* § 1.987-2(c)(2)(iii).

The final regulations provide rules for determining the basis of an asset or the amount of a liability that has been transferred by an owner to a section 987 QBU. In general, marked items are translated into the section 987 QBU's functional currency at the spot rate applicable on the date of the transfer, while historic items are translated at the applicable historic rate. *See* § 1.987-2(d). Similarly, when an asset or liability is transferred from a section 987 QBU to its owner, marked items are translated into the owner's functional currency at the spot rate applicable on the date of transfer, while historic items are translated at the applicable historic rate. *See* § 1.987-5(f). These rules apply to all transfers of assets and liabilities between a section 987 QBU and its owner, including

[1] The reference to "this subpart" refers to subpart J of part III of subchapter N of chapter 1 of the Code, which includes section 987.

transfers made in connection with ordinary course disregarded transactions (for example, sales of inventory).

The definition of a marked item under the final regulations includes an asset or liability denominated in, or determined by reference to, the functional currency of the section 987 QBU that would be a section 988 transaction if it were held or entered into directly by the owner of the section 987 QBU; it also includes several other categories of assets and liabilities. *See* § 1.987-1(d)(1). However, the final regulations provide an election to treat all items of a section 987 QBU as marked items (the "current rate election"). *See* § 1.987-1(d)(2).

B. *Determination of unrecognized section 987 gain or loss with respect to a section 987 QBU*

Section 1.987-4 provides rules for computing net unrecognized section 987 gain or loss with respect to a section 987 QBU. Under § 1.987-4(b), net unrecognized section 987 gain or loss is equal to the sum of (i) the unrecognized section 987 gain or loss for the current taxable year and (ii) net accumulated unrecognized section 987 gain or loss for all prior taxable years.

Section § 1.987-4(d) provides a ten-step formula for computing unrecognized section 987 gain or loss for the current taxable year. The first step of this formula is to determine the change in owner functional currency net value ("OFCNV") of the section 987 QBU for the taxable year, computed using end-of-year exchange rates for marked items and historic rates for historic items. *See* § 1.987-4(d)(1) and (e). The other steps adjust for amounts comprising the separate components of the annual change in OFCNV (other than changes in the exchange rate). Steps 2 through 5 relate to transfers of assets and liabilities between a section 987 QBU and its owner, and steps 6 through 9 relate to items of income or loss of the section 987 QBU. *See* § 1.987-4(d)(2) through (9). Step 10 is a residual adjustment for any remaining increase or decrease to the section 987 QBU's functional currency balance sheet. This residual adjustment is translated into the owner's functional currency using the yearly average exchange rate for the taxable year. *See* § 1.987-4(d)(10).

In applying steps 2 through 5, an owner must account for all transfers of assets and liabilities between a section 987 QBU and its owner, including transfers made in connection with ordinary course disregarded transactions. *See* § 1.987-4(d)(2) through (5). For this purpose, marked items are translated into the owner's functional currency at the spot rate applicable on the date of the transfer, while historic items are translated at the applicable historic rate.

II. *Proposed Rules Relating to Disregarded Transactions*

A. *Comment concerning the compliance burden of accounting for disregarded transactions*

A comment to the 2023 proposed regulations asserted that it is burdensome for taxpayers to track and translate disregarded transactions between a section 987 QBU and its owner (or between different section 987 QBUs of the same owner) that arise in the ordinary course of a section 987 QBU's trade or business. The comment recommended that, for taxpayers that make a current rate election, unrecognized section 987 gain or loss for the taxable year should be computed by applying only two of the steps provided in § 1.987-4(d): step 1 (determining the change in OFCNV) and step 10 (reducing or increasing the amount determined in step 1 by the change in QBU net value, translated into the owner's functional currency at the yearly average exchange rate). The comment asserted that, under this approach, it would not be necessary to track ordinary course disregarded transactions between a section 987 QBU and its owner (or different section 987 QBUs of the same owner), because those transactions would be eliminated from the computation of unrecognized section 987 gain or loss.

As explained in the preamble to the final regulations, the effect of the comment's recommended rule would be to translate the net amount of all transfers between a section 987 QBU and its owner at the yearly average exchange rate under step 10. *See* part V.A.3 of the Summary of Comments and Explanation of Revisions in the preamble to the final regulations. By contrast, § 1.987-4(d) requires each transfer to be translated at the appropriate exchange rate in applying steps 2 through 5. Under the final regulations, if a current rate election is in effect, the basis of each asset and the amount of each liability transferred is translated at the spot rate applicable on the date of transfer (because all assets and liabilities are treated as marked items). The final regulations do not adopt the rule recommended by the comment because the applicable spot rate could be significantly higher or lower than the yearly average exchange rate, in which case the comment's recommended rule could substantially distort the computation of unrecognized section 987 gain or loss.

B. *Recurring transfer group election*

Notwithstanding the concern described in part II.A of this Explanation of Provisions, the Treasury Department and the IRS are of the view that, in certain cases, a group of frequently recurring transfers between a section 987 QBU and its owner could be translated using the yearly average exchange rate without creating significant distortions. Further, permitting taxpayers to use the yearly average exchange rate in lieu of the applicable spot rate would reduce the compliance burden of the section 987 regulations.

Therefore, the proposed regulations would provide that a taxpayer that has made a current rate election may elect to use the yearly average exchange rate to translate assets that are transferred between a section 987 QBU and its owner as part of a recurring transfer group (a "recurring transfer group election"). Proposed § 1.987-2(f)(1). The recurring transfer group election would be subject to the general timing and consistency requirements provided in § 1.987-1(g) of the final regulations.

If a recurring transfer group election is in effect, assets transferred between a section 987 QBU and its owner as part of a recurring transfer group ("grouped assets") are translated under §§ 1.987-2(d), 1.987-4(d)(2), and 1.987-5(f) using the yearly average exchange rate in lieu of the applicable spot rate. Proposed § 1.987-2(f)(4). In addition, proposed § 1.987-2(f)(5)(i) would provide that transfers made as part of a recurring transfer group are disregarded for purposes of § 1.987-4(d)(2) and (3) (steps 2 and 3). Proposed § 1.987-2(f)(5). That is, because all transfers that are part of a recurring transfer group are translated at the yearly average exchange rate, these transfers do not need to be separately tracked and translated for purposes of determining unrecognized section 987 gain or loss.

Transfers that are part of a recurring transfer group are also disregarded when applying steps 2 and 3 in the functional currency of the section 987 QBU for purposes of determining the residual increase or decrease to net assets under § 1.987-4(d)(10). Proposed § 1.987-4(d)(10)(ii)(D). To the extent that these transfers increase or reduce the year-end net assets of the section 987 QBU (determined in the section 987 QBU's functional currency), the residual increase or decrease to net assets will be translated at the yearly average exchange rate under § 1.987-4(d)(10) (step 10).

Under the proposed regulations, if a recurring transfer group election is in effect, and the only transfers between a section 987 QBU and its owner are part of a recurring transfer group, the owner would determine unrecognized section 987 gain or loss for the taxable year by applying only steps 1 and 10 (as recommended by the comment). Transfers that are not part of a recurring transfer group must be taken into account at the applicable spot rate under steps 2 through 5. However, the final regulations permit taxpayers to use a spot rate convention based on the average of spot rates for a reasonable period (which can be as long as three months), which should reduce the compliance burden of accounting for these transfers. *See* § 1.987-1(c)(1)(ii).

The special rule for computing unrecognized section 987 gain or loss in proposed § 1.987-2(f)(5)(i) would not apply if the owner of a section 987 QBU determines QBU net value using the formula provided in § 1.987-4(e)(2)(iii). Proposed § 1.987-2(f)(5)(ii). Taxpayers using this formula must separately track each transfer for purposes of computing QBU net value, and therefore disregarding the transfers for purposes of § 1.987-4(d)(2) and (3) would not reduce the compliance burden for these taxpayers.

The proposed regulations also would modify the recordkeeping requirements in § 1.987-9 to provide that taxpayers are not required to maintain records concerning amounts transferred between an owner and a section 987 QBU unless the transferred amounts are taken into account in applying § 1.987-4 or § 1.987-5. Proposed § 1.987-9(b)(5) and (6). Therefore, if a taxpayer makes a recurring transfer group election and uses the alternative calculation provided in § 1.987-5(c)(2) (under which the remittance for a taxable year is determined by reference to the change in QBU net value, adjusted for income or loss of the section 987 QBU), the taxpayer generally would not be required to maintain records with respect to transfers of grouped assets.

C. *Definition of a recurring transfer group*

Under the proposed regulations, a recurring transfer group would be defined as a group of frequently recurring transfers between a section 987 QBU and its owner (or another eligible QBU of the owner) that are made in the ordinary course of a trade or business. Proposed § 1.987-2(f)(2)(i). Only transfers made in connection with sales of inventory, payments for services, or rent or royalty transactions in which arm's length compensation (determined by applying the principles of the arm's length standard of § 1.482-1(b)(1)) has been paid would be included in a recurring transfer group. Proposed § 1.987-2(f)(2)(ii). For this purpose, the principles of the arm's length standard apply as if the section 987 QBU were a corporation that is separate from its owner and, thus, as if the disregarded transaction were a controlled transfer within the meaning of § 1.482-1(i)(8). A recurring transfer group would not include a transfer between the section 987 QBU and its owner if the transfer (or a portion of the transfer) would be treated as a distribution with respect to stock, or an exchange for stock (or a contribution to capital), for U.S. tax purposes if the QBU were treated as a separate corporation. Proposed § 1.987-2(f)(2)(iii). Those transfers are unlikely to be made in the ordinary course of a trade or business and could be used to manipulate the computation of unrecognized section 987 gain or loss.

The definition of a recurring transfer group in proposed § 1.987-2(f)(2) is tailored to identify ordinary business transactions for which the use of the yearly average exchange rate would not cause significant distortions and which could be burdensome to account for under the rules of the final regulations. The Treasury Department and the IRS request comments as to whether other transfers should be included in a recurring transfer group. For example, comments are requested as to whether intercompany lending transactions (or other transactions) of a bank or other financial entity should be included in a recurring transfer group and, if so, how the scope of the covered transactions should be defined. Although lending transactions are made in the ordinary course of a bank's trade or business, it may be difficult to distinguish between ordinary course loans and extraordinary transactions that could be used to manipulate a taxpayer's unrecognized section 987 gain or loss.

D. *Exception for disproportionate transfers*

The rules of proposed § 1.987-2(f)(4) and (5) would not apply in a taxable year in which a disproportionate amount of the assets transferred as part of a recurring transfer group are transferred during one or more quarters of the taxable year. Proposed § 1.987-2(f)(6). In particular, proposed § 1.987-2(f)(4) and (5) would not apply if either (i) more than 50 percent of the total amount transferred during the taxable year is transferred during one quarter of the taxable year or (ii) more than 80 percent of the total amount transferred during the taxable year is transferred during two quarters of the taxable year.

The exception in proposed § 1.987-2(f)(6) is intended to prevent significant distortions that could arise from using the yearly average exchange rate to translate transfers that primarily occur in only part of the taxable year, while being flexible enough to accommodate ordinary course disregarded transactions between a section 987 QBU and its owner. The Treasury Department and the IRS request comments as to whether other standards could be used to identify transfers that can appropriately be translated at the yearly average exchange rate. For example, comments are requested as to whether more flexibility should be provided in taxable years in which exchange rates do not significantly fluctuate.

Applicability Dates

Once finalized, the regulations would apply to taxable years beginning after the date the Treasury Decision adopting these rules as final regulations is published in the **Federal Register**. A taxpayer may rely on these proposed regulations for a taxable year in which the final regulations (that is, the final regulations that are being published concurrently with the proposed regulations) apply, provided the taxpayer and each member of its consolidated group and section 987 electing group, as applicable, consistently follow the proposed regulations in their entirety and in a consistent manner.

In addition, for a taxable year in which the final regulations apply, a taxpayer may continue to rely on the parts of the proposed regulations published in the **Federal Register** (REG-128276-12, 81 FR 88882) on December 8, 2016 (the "2016 proposed regulations") that have not been finalized or withdrawn, provided that the taxpayer and each member of its consolidated group and section 987 electing group, as applicable, consistently follow these parts in their entirety and in a consistent manner. The following parts of the 2016 proposed regulations have not been finalized or withdrawn: (1) rules regarding QBUs with the U.S. dollar as their functional currency (*see* §§ 1.987-1 and 1.987-6 of the 2016 proposed regulations); and (2) rules requiring the deferral of certain section 988 loss that arises with respect to related-party loans (*see* § 1.988-2 of the 2016 proposed regulations).

Comments and Request for Public Hearing

I. *In General*

Before these proposed regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. In addition to the specific requests for comments in parts II.C and II.D of the Explanation of Provisions, the Treasury Department and the IRS request comments on all other aspects of the proposed regulations as well as on the specific issues identified in part II of this Comments and Request for Public Hearing section. Any comments submitted will be made available at *https://www.regulations.gov* or upon request.

A public hearing concerning the proposed regulations will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**.

II. *Additional Requests for Comments*

A. *Treatment of partnerships for purposes of sections 987 and 989(a)*

The final regulations do not provide detailed rules concerning the application of section 987 to partnerships, and they reserve on the treatment of a partnership as a QBU under section 989(a). *See* part VIII.B.1 of the Summary of Comments and Explanation of Revisions in the preamble to the final regulations. *See* also part VIII of the Explanation of Provisions in the preamble to the 2023 proposed regulations. The Treasury Department and the IRS continue to study those issues and therefore request comments on the following topics:

1. Should section 987 be applied to partnerships using an entity approach, an aggregate approach, or a hybrid approach? Comments recommending an entity approach should address the concerns raised in the preamble to the 2023 proposed regulations regarding the potential for unrecognized section 987 gain or loss to be shifted between partners upon a sale of a partnership interest. *See* part VIII.C of the Explanation of Provisions in the preamble to the 2023 proposed regulations.
2. Should a partnership be treated as a per se QBU under section 989(a) and § 1.989(a)-1(b)(2)(i)?
3. Should different rules be provided for purposes of sections 987 and 989(a) depending on whether the partners in the partnership are related parties? Comments recommending an entity approach for partnerships owned by related parties should address the concerns raised in the preamble to the 2023 proposed regulations regarding the potential for a group of related parties to hold an eligible QBU through a partnership (rather than directly) in order to alter the section 987 treatment of the eligible QBU without meaningfully altering the group's economic position. *See* part VIII.E of the Explanation of Provisions in the preamble to the 2023 proposed regulations.
4. Under an entity approach, if a partnership's functional currency differs from that of its partners, how should the partners account for currency gain or loss with respect to their partnership interests?

Comments submitted in response to the 2023 proposed regulations do not need to be resubmitted in response to these proposed regulations.

B. *Application of section 987 to CFCs*

As discussed in part II.A.3 of the Summary of Comments and Explanation of Revisions in the preamble to the final regulations, a comment on the 2023 proposed regulations recommended that the application of section 987 be simplified by applying rules similar to section 986(c) to section 987 QBUs owned by CFCs in lieu of applying section 987. In response to this comment, the preamble to the final regulations explained that the Treasury Department and the IRS are of the view that it would not be feasible to adopt this comment, but nonetheless are studying whether there are instances in which it would be possible to simplify the application of section 987 by modifying the application of section 987(3) (and the related regulations, including §§ 1.987-4 through 1.987-6, 1.987-8, and 1.987-11 through 1.987-13) to certain entities.

In considering the appropriateness of such a rule, it is helpful to consider United States persons ("U.S. persons") and foreign persons separately. In the case of a U.S. person, except to the extent that the Code specifically provides otherwise, the taxable income of the U.S. person should reflect that person's accession to wealth, as measured in the U.S. dollar. Accordingly, when the amount of the U.S. person's basis in its assets or the amount of its liabilities fluctuates as a result of fluctuations in the functional currency of a section 987 QBU, section 987(3) is necessary to ensure that currency gain or loss is taken into account to prevent these fluctuations from artificially increasing or decreasing the taxpayer's income, gain, deduction, and loss, as measured in the U.S. dollar. In contrast, in the case of a foreign person, such as a CFC or a partnership with only foreign partners, the Treasury Department and the IRS are studying whether the U.S. tax system appropriately tracks and taxes the foreign person's accession to wealth given that its functional currency may not be the U.S. dollar.

The Treasury Department and the IRS agree with the comment that the compliance and administrative burdens of the section 987 regulations would be substantially reduced if section 987(3) and the related regulations did not apply to CFCs or to partnerships with only foreign partners. Under such an approach, a CFC or a partnership with only foreign partners would not calculate net unrecognized section 987 gain or loss with respect to a section 987 QBU and would not recognize section 987 gain or loss on a remittance or termination. Instead, if a section 987 QBU owned by the CFC or partnership transferred assets or liabilities to its owner, the CFC or partnership would merely take a basis in the assets or measure the amount of the liabilities by translating from the section 987 QBU's functional currency into the CFC or partnership's functional currency at the spot rate on the date of the transfer.

Relatedly, the Treasury Department and the IRS are concerned about the ability of foreign entities to manipulate the recognition of section 987 gain and loss under section 987(3) and the related regulations. This concern is not entirely alleviated by the loss-to-the-extent-of-gain-rule in § 1.987-11, which suspends the recognition of section 987 loss for taxpayers that make a current rate election.

Accordingly, the Treasury Department and the IRS are studying whether, in certain cases, it would be appropriate to not apply section 987(3) and the related regulations to CFCs and partnerships with only foreign partners. However, the Treasury Department and the IRS have a number of concerns, including that, under this approach, the amount of currency gain (or loss) that would have been taken into account under section 987(3) would give rise to an increase (or decrease) in a CFC's aggregate inside asset basis without a corresponding change in the CFC's earnings and profits, and the resulting mismatch between inside asset basis and earnings and profits could produce inappropriate results.

For example, over time, it would be common for a CFC's aggregate inside asset basis to be greater or less than the sum of its (i) earnings and profits determined under the principles of § 1.367(b)-2(d) but without regard to whether the exchanging shareholder is a U.S. person or foreign person, (ii) total basis in the stock of the CFC; and (iii) the amount of the CFC's liabilities. Although it is possible for a CFC to have aggregate inside asset basis in excess of these amounts ("excess asset basis")[2] under current law, the Treasury Department and the IRS are concerned that, if CFCs were not required to recognize currency gain or loss under section 987(3), excess asset basis would become more prevalent. If the United States shareholder ("U.S. shareholder") ultimately sells its stock in the CFC, the U.S. shareholder would generally recognize the appropriate amount of gain or loss on the sale of stock (notwithstanding the potential excess asset basis of the CFC). However, if, in lieu of a sale of stock, the CFC merges or liquidates into a domestic corporation pursuant to an inbound asset reorganization or liquidation described in § 1.367(b)-3, the excess asset basis could be imported into the United States without a corresponding inclusion of income or gain under § 1.367(b)-3, and thus permanently escape U.S. taxation.

Accordingly, the Treasury Department and the IRS request comments concerning the following topics:

1. Should the final regulations be modified to provide that section 987(3) and the related regulations do not apply to CFCs or to partnerships with only foreign partners? If so, how should currency gain or loss be recognized with respect to the section 987 QBU (if at all)?
2. If section 987(3) did not apply to CFCs and partnerships with only foreign partners, what other rules would be needed to prevent value equal to the amount of excess asset basis from permanently escaping U.S. taxation upon an inbound transaction such as an asset reorganization or liquidation described in § 1.367(b)-3? For example, should the importation of excess asset basis trigger the recognition of gain in the same manner that § 1.367(b)-3 triggers a deemed dividend to a shareholder? If so, are there circumstances in which excess asset basis should not trigger gain (such as excess asset basis arising by reason of section 362(e) or by reason of minority interests)? How should excess asset basis be computed? What additional rules would be needed to similarly prevent taxpayers from planning into the permanent avoidance or indefinite deferral of gain or acceleration of losses?
3. If section 987(3) and the related regulations continue to apply to CFCs and partnerships with only foreign partners generally, are any modifications needed to the calculation of section 987 gain and loss for these entities?

Special Analyses

I. *Regulatory Planning and Review – Economic Analysis*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as

[2] For a discussion of "excess asset basis," see the preambles accompanying issuance of § 1.367(b)-3(g) (TD 10004, 89 FR 58275) and proposed § 1.367(b)-3(g) (88 FR 69559), respectively.

amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) (PRA) requires that a Federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. 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 OMB.

The collections of information in the proposed regulations with respect to section 987 are in proposed § 1.987-2(f)(1) (and the related election rules in § 1.987-1(g) of the final regulations). The likely respondents are individuals who file a Form 1040 and businesses that file a Form 1065 or Form 1120.

The collection of information in proposed § 1.987-2(f)(1) is required only when a taxpayer makes or revokes a recurring transfer group election under proposed § 1.987-2(f)(1). In the first year in which the section 987 regulations apply to a taxpayer, or the first year in which the taxpayer or a member of its consolidated group or section 987 electing group is the owner of a section 987 QBU, the taxpayer is permitted to make a recurring transfer group election without the Commissioner's consent. Thereafter, the taxpayer may make or revoke a recurring transfer group election only with the consent of the Commissioner, which may be granted with a private letter ruling. When a taxpayer makes or revokes an election, the collection of information is mandatory. The collection of information required by proposed § 1.987-2(f)(1) will be used by the IRS for tax compliance purposes.

The Treasury Department and the IRS intend that the information required by § 1.987-1(g) with respect to a recurring transfer group election under proposed § 1.987-2(f)(1) will be collected by attaching a statement to a taxpayer's return (such as the appropriate Form 1040, Form 1120, Form 1065, or other appropriate forms). For purposes of the PRA, the reporting burden associated with those collections of information will be reflected in the PRA submissions associated with those forms. The OMB Control Numbers for the forms will be approved under 1545–0074 for individuals and under 1545–0123 for business entities.

To the extent that a taxpayer makes or revokes an election by obtaining a private letter ruling, the reporting burden associated with those collections of information will be reflected in the PRA submissions associated with revenue procedures governing private letter rulings. The OMB Control Number for those revenue procedures is control number 1545-1522. The proposed regulations would only require taxpayers to follow the procedures under Revenue Procedure 2024-1, IRB 2024-1 (or future revenue procedures governing private letter rulings) and would not change the collection requirements of the Revenue Procedure.

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

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this rulemaking will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. The proposed regulations affect individuals and corporations (other than S corporations) with foreign branch operations.

The number of small entities potentially affected by the proposed regulations is unknown; however, it is unlikely to be a substantial number because taxpayers with wholly owned foreign operations are typically larger businesses. The Treasury Department and the IRS estimate that the total number of corporations (other than S corporations) with a foreign branch subject to section 987 is approximately 2,000. This estimate is based on the number of corporations (other than S corporations) that filed a Form 8858 in 2022 that showed that the filer: (1) owned at least one disregarded entity or branch with a functional currency different from the functional currency of the owner, and (2) indicated that the disregarded entity or branch was a section 989 QBU. As shown in the following table, only a small percentage of those filers are small entities.

Total Receipts/Positive Income (2022)	Percentage of Filers
Under $5 Million	7%
$5 Million to $10 Million	2%
$10 Million to $25 Million	4%
Over $25 Million	87%

The number of affected corporations (other than S corporations) with total receipts of less than $25 million represents 0.02% of all corporations (other than S corporations) with total receipts of less than $25 million.

These proposed regulations generally modify the rules that would otherwise apply under the final regulations by providing taxpayers with an election that reduces the compliance burden of applying section 987. Small entities generally would not be affected by these rules unless they choose to make an election to reduce their compliance burden.

A portion of the economic impact of the proposed regulations may derive from the collection of information requirements imposed under proposed § 1.987-2(f)(1) (and the related election rules in § 1.987-1(g) of the final regulations). The Treasury Department and the IRS have determined that the average burden is 1.95 hours per response. The IRS's Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is $99.87 per hour. Thus, the annual burden per taxpayer from each collection of information requirement is $194.75. The requirements of proposed § 1.987-2(f)(1) apply only if a taxpayer chooses to make or revoke an election (and only in the year of the election or revocation).

IV. *Section 7805(f)*

Pursuant to section 7805(f) of the Code, this proposed regulation will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

Drafting Information

The principal authors of these proposed regulations are Adam G. Province and Raphael J. Cohen of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 ***

* * * * *

Section 1.987-2 also issued under 26 U.S.C. 987, 989, and 1502.

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Section 1.987-4 also issued under 26 U.S.C. 987 and 989.

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Section 1.987-9 also issued under 26 U.S.C. 987, 989, and 6001.

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Section 1.987-15 also issued under 26 U.S.C. 987 and 989.

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Par. 2. Section 1.987-2 is amended by adding paragraph (f) to read as follows:

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

* * * * *

(f) Recurring transfer group election—(1) In general. For a taxable year in which a current rate election is in effect, the owner of a section 987 QBU may elect to use the yearly average exchange rate to translate all assets that are transferred to or from the section 987 QBU in a taxable year as part of a recurring transfer group (a recurring transfer group election). The rules of this paragraph (f) apply to all transfers that are part of a recurring transfer group in any taxable year to which the recurring transfer group election applies (regardless of whether transfers of the same kind occurred in the first year to which the election applied).

(2) Recurring transfer group. A recurring transfer group is a group of frequently recurring transfers made between a section 987 QBU and its owner (or another eligible QBU of the owner) in a taxable year that meet the requirements of paragraphs (f)(2)(i) through (iii) of this section.

(i) Ordinary course transfers. The transfers must be made in the ordinary course of a trade or business.

(ii) Specified transactions. The transfers must be made as part of one or more disregarded transactions described in paragraphs (f)(2)(ii)(A) through (C) of this section between the section 987 QBU and its owner (or another eligible QBU of the owner), the compensation for which would satisfy the principles of the arm's length standard (within the meaning of § 1.482-1(b)) if the section 987 QBU were treated as a separate corporation. Transfers made in connection with different disregarded transactions described in paragraphs (f)(2)(ii)(A) through (C) of this section in the same taxable year are treated as part of a single recurring transfer group.

(A) Sales of inventory;

(B) Payments for services;

(C) Rents or royalties.

(iii) *Distributions and contributions excluded*. A transfer is not included in a recurring transfer group if the transfer (or any portion of the transfer) would be treated as a distribution with respect to stock, or an exchange for stock (or a contribution to capital), if the section 987 QBU were treated as a separate corporation.

(3) *Consistency requirement*. The determination as to which transfers are included in a recurring transfer group must be made consistently from year to year. However, this determination may change from one year to the next based on changes in the nature and timing of the relevant transfers.

(4) *Effect of recurring transfer group election*. Except as provided in paragraph (f)(6) of this section, in a taxable year in which a recurring transfer group election is in effect, assets that are transferred to or from a section 987 QBU in a taxable year as part of a recurring transfer group (*grouped assets*) are translated under paragraph (d) of this section and §§ 1.987-4(d)(2) and 1.987-5(f) by deeming the spot rate applicable on the date of each transfer to be equal to the yearly average exchange rate for the taxable year. However, if the Commissioner determines that the use of the yearly average exchange rate to translate grouped assets in a taxable year does not clearly reflect income, the Commissioner may require some or all transfers of the grouped assets to be excluded from the recurring transfer group or may prescribe the use of a different exchange rate to translate the grouped assets.

(5) *Accounting for a disregarded transfer group in determining unrecognized section 987 gain or loss for the taxable year*—(i) *In general*. Except as provided in paragraph (f)(5)(ii) or (f)(6) of this section, in a taxable year in which a recurring transfer group election is in effect, transfers of grouped assets are disregarded for purposes of § 1.987-4(d)(2) and (3) (steps 2 and 3).

(ii) *Exception*. Paragraph (f)(5)(i) of this section does not apply to a section 987 QBU in a taxable year in which the owner determines QBU net value with respect to the section 987 QBU under the steps provided in § 1.987-4(e)(2)(iii) (alternative formula for determining QBU net value without preparing an adjusted balance sheet).

(6) *Exception for taxable years in which a disproportionate amount of grouped assets is transferred in one or more quarters of the taxable year*—(i) *In general*. Paragraphs (f)(4) and (5) of this section do not apply to a section 987 QBU in a taxable year in which—

(A) More than 50 percent of the total amount of grouped assets transferred to or from the section 987 QBU during the taxable year is transferred during one quarter of the taxable year; or

(B) More than 80 percent of the total amount of grouped assets transferred to or from the section 987 QBU during the taxable year is transferred during two quarters of the taxable year.

(ii) *Amount of grouped assets transferred*. For the purpose of applying paragraph (f)(6)(i) of this section, the amount of grouped assets transferred to or from a section 987 QBU in a taxable year and in each quarter of the taxable year is determined in the functional currency of the section 987 QBU by reference to the aggregate of the amount of functional currency transferred and the basis of the other assets transferred (taking into account the total gross amount of both the transfers from the section 987 QBU to the owner or another eligible QBU of the owner and the transfers from the owner or another eligible QBU of the owner to the section 987 QBU). For this purpose, amounts transferred from the owner (or another eligible QBU of the owner) to the section 987 QBU are translated into the section 987 QBU's functional currency at the yearly average exchange rate.

(iii) *Short taxable year*. For purposes of applying this paragraph (f)(6) in a short taxable year, each quarter comprises a number of days equal to one fourth of the total number of days in the taxable year. If a section 987 QBU did not exist for the full taxable year of the owner, this paragraph (f)(6) is applied with respect to the section 987 QBU by treating the taxable year as comprising the portion of the taxable year in which the section 987 QBU existed.

(7) *Examples*. The following examples illustrate the application of this paragraph (f). For purposes of the examples, DC1 is a domestic corporation that owns Business A, a section 987 QBU that has the euro as its functional currency. In year 1, DC1's home office provides services to Business A in exchange for arm's length cash payments (within the meaning of § 1.482-1(b)). The payments are made in the ordinary course of the Business A trade or business. A current rate election and a recurring transfer group election are in effect for year 1. DC1 does not determine QBU net value with respect to Business A under the steps provided in § 1.987-4(e)(2)(iii).

(i) *Example 1: Transfers treated as part of a recurring transfer group*—(A) *Facts*. In year 1, Business A made 50 payments for services to DC1's home office, totaling €30,000x. Of this amount, Business A paid €5,000x in the first quarter of year 1, €7,500x in the second quarter of year 1, €10,000x in the third quarter of year 1, and €7,500x in the fourth quarter of year 1. No other transfers were made between Business A and DC1 for year 1.

(B) *Analysis*—(*1*) *Recurring transfer group*. Under paragraph (c)(2) of this section, each payment for services is treated as a transfer of assets from Business A to DC1. These transfers qualify as a recurring transfer group under paragraph (f)(2) of this section because they are frequently recurring payments for services made in the ordinary course of the Business A trade or business that would satisfy the principles of the arm's length standard (within the meaning of § 1.482-1(b)) if Business A were treated as a separate corporation. In addition, the exception in paragraph (f)(6) of this section does not apply because Business A did not transfer more than 50 percent of the total amount of grouped assets transferred in year 1 in any one quarter, and Business A did not transfer more than 80 percent of the total amount of grouped assets transferred in year 1 in any two quarters.

(*2*) *Effect of recurring transfer group election*. Under paragraph (f)(4) of this section, because Business A's transfers to DC1 comprise a recurring transfer group, DC1 applies § 1.987-5(f) by deeming the spot rate applicable on the date of each transfer to be equal to the yearly average exchange rate for year 1. As a result, DC1 determines its basis in the euros received from Business A by translating the total amount of euros transferred in year 1 at the yearly average exchange rate for year 1. In addition, under paragraph (f)(5) of this section, the transfers are disregarded for purposes of determining unrecognized section 987 gain or loss for year 1 under § 1.987-4(d)(2).

(ii) *Example 2: Disproportionate transfers*—(A) *Facts*. The facts are the same as in paragraph (f)(7)(i) of this section (*Example 1*), except that most of the payments are made in the fourth quarter of year 1 to compensate DC1's home office for additional services provided at the end of year 1. Specifically, of the €30,000 paid by Business A for services in year 1, €18,000x is transferred in the fourth quarter of year 1, and €4,000x is transferred in each of the first three quarters of year 1.

(B) *Analysis*. The amount of grouped assets transferred in the fourth quarter (€18,000x) exceeds 50 percent of the total amount of grouped assets transferred in year 1 (€30,000x). Therefore, under paragraph (f)(6) of this section, paragraphs (f)(4) and (5) of this section do not apply. As a result, DC1 determines its basis in the euros received from Business A by translating each transfer at the applicable spot rate under § 1.987-5(f), and DC1 must take each transfer into account for purposes of determining unrecognized section 987 gain or loss for year 1 under § 1.987-4(d)(2).

(iii) *Example 3: Determination of the transfers including in a recurring transfer group over multiple taxable years*—(A) *Facts*. The facts in year 1 are the same as in paragraph (f)(7)(i) of this section (*Example 1*). The recurring transfer group election remains in effect in years 2 and 3. In year 2, DC1's home office continues to provide services to Business A in exchange for arm's length cash payments made in the ordinary course of the Business A trade or business. Additionally, in year 2, Business A begins to sell Product X inventory to Business B, an eligible QBU of DC1 that is not a section 987 QBU, in exchange for arm's length cash payments. In year 3, DC1's home office no longer provides services to Business A, but Business A continues to sell Product X inventory to Business B in exchange for arm's length cash payments. Additionally, in year 3, Business A begins to sell Product Y inventory to Business B in exchange for arm's length cash payments. In each of years 1, 2, and 3, the transfers to and from Business A are made on a frequent basis in the ordinary course of the Business A trade or business.

(B) *Analysis*. In year 1, the cash payments for services made by Business A to DC1's home office are part of a recurring transfer group. In year 2, the recurring transfer group includes the cash payments for services made by Business A to DC1's home office, the transfers of Product X inventory from Business A to Business B, and the cash payments made by Business B to Business A in connection with the inventory sales. In year 3, the recurring transfer group includes the transfers of Product X inventory and Product Y inventory from Business A to Business B and the cash payments made by Business B to Business A in connection with the inventory sales. Therefore, in each of years 1, 2, and 3, unless the exception in paragraph (f)(6) of this section applies, the grouped assets are translated at the yearly average exchange under paragraph (f)(4) of this section, and the transfers of the grouped assets are disregarded for purposes of determining unrecognized section 987 gain or loss under § 1.987-4(d)(2) and (3).

* * * * *

Par. 3. Section 1.987-4 is amended by adding paragraph (d)(10)(ii)(D) to read as follows:

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

* * * * *

(d) * * *

(10) * * *

(ii) * * *

(D) *Recurring transfer group*. In order to determine the residual increase or decrease to net assets under this paragraph (d)(10) in a taxable year in which transfers of grouped assets are disregarded under § 1.987-2(f)(5), the transfers of grouped assets are disregarded for purposes of applying steps 2 and 3 (paragraphs (d)(2) and (3) of this section) in the functional currency of the section 987 QBU.

* * * * *

4. Section 1.987-9 is amended by revising paragraphs (b)(5) and (6) to read as follows:

§ 1.987-9 Recordkeeping requirements.

* * * * *

(b) * * *

(5) The amount of assets and liabilities transferred by the owner to the section 987 QBU determined in the functional currency of the owner and the section 987 QBU (to the extent those amounts are taken into account in applying § 1.987-4 or § 1.987-5).

(6) The amount of assets and liabilities transferred by the section 987 QBU to the owner determined in the functional currency of the owner and the section 987 QBU (to the extent those amounts are taken into account in applying § 1.987-4 or § 1.987-5).

* * * * *

5. Section 1.987-15 is amended by adding paragraph (e) to read as follows:

§ 1.987-15 Applicability date.

* * * * *

(e) *Recurring transfer group election*. Sections 1.987-2(f),1.987-4(d)(10)(ii)(D), and 1.987-9(b)(5) and (6) apply to taxable years beginning after [DATE OF PUBLICATION OF THE FINAL RULE IN THE **FEDERAL REGISTER**].

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register December 10, 2024, 8:45 a.m., and published in the issue of the Federal Register for December 11, 2024, 89 FR 99782)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2024–27 through 2024–52 is in Internal Revenue Bulletin 2024–52, dated December 23, 2024.

Finding List of Current Actions on Previously Published Items[1]

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2024–27 through 2024–52 is in Internal Revenue Bulletin 2024–52, dated December 23, 2024.

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We Welcome Comments About the Internal Revenue Bulletin

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