



US International Tax Alert

Treasury, IRS release final and proposed regulations under section 987 and related rules

On December 11, 2024, Treasury and the IRS released [final currency regulations under section 987](#) and related rules (the “Final Regulations”). Section 987 generally applies to taxpayers with a “flow-through” qualified business unit (QBU) if the QBU has a functional currency that is different than the functional currency of its tax owner(s) (a “Section 987 QBU”). Section 987 addresses foreign currency translation related to operations, assets, and liabilities of Section 987 QBUs, and provides rules for (i) computing taxable income (and associated earnings and profits) attributable to the Section 987 QBU, (ii) recognizing currency gain or loss, and (iii) translating basis in property that is transferred between a Section 987 QBU and its tax owner.

The Final Regulations generally retain the key elements of the proposed regulations issued in November 2023 (the “2023 Regulations”), including (i) the requirement that pre-transition gain or loss be computed upon transition to the final regulations; (ii) application of the foreign exchange exposure pool (FEEP) method and delineation between marked and historic assets as a default approach in determining taxable income and section 987 gain or loss; (iii) various elections (including amortization, current rate election (CRE), annual recognition election (ARE), etc.); (iv) deferral and loss suspension rules; (v) rules for sourcing and characterization of section 987 gain or loss; and (vi) applicability of the rules to a broad group of taxpayers.

The Final Regulations also introduce a number of changes with respect to the 2023 Regulations that are intended to provide certain administrative and substantive relief. In addition, the Final Regulations largely exclude partnerships from their scope, except for a few specific provisions. However, the Final Regulations require partnerships treated as QBUs and QBUs owned by partnerships to comply with section 987 using a reasonable method.

The Final Regulations are effective December 10, 2024, and generally apply to taxable years beginning after December 31, 2024. For QBUs that terminated after November 8, 2023, and before the regular applicability date of the Final Regulations (“terminating QBUs”), the Final Regulations generally apply at the time of such termination.

Treasury and the IRS also issued proposed regulations¹ (the “2024 Proposed Regulations”) that mainly provide an election for the simplified treatment of certain recurring ordinary-course disregarded transactions between an owner and its section 987 QBU.

¹ Accounting for Disregarded Transactions Between a Qualified Business Unit and Its Owner, 89 Fed. Reg. 99782 (proposed Dec. 11, 2024).

In this alert, we provide highlights of the Final Regulations and the 2024 Proposed Regulations.

Applicability date and coordination with other guidance

- The Final Regulations apply to taxable years beginning after December 31, 2024,² with a retroactive effect for terminating QBUs.
- Taxpayers may rely on the 2024 Proposed Regulations for a taxable year in which the Final 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.
- The Final Regulations removed and reserved on the definition of a QBU under Treas. Reg. § 1.989(a)-1(b)(2)(i)(C) for partnerships and aggregate partnerships.

Executive summary

- **Transition:**
 - No more fresh start transition – taxpayers must preserve pre-transition currency gains and losses.
 - If the taxpayer has applied an eligible pre-transition method before the transition date, pre-transition gains and losses generally are determined based on such method; otherwise, they are determined using a simplified approach provided in the Final Regulations.
 - Taxpayers can elect to amortize pre-transition gains and losses over 10 years. Absent such election, and without making a CRE, the pre-transition gain would be added to future unrecognized section 987 gain or loss, and the pre-transition loss would be subject to the suspended loss rules.
 - If a taxpayer makes a CRE (but not an ARE), pre-transition loss is not suspended, but instead would be added to future unrecognized section 987 gain or loss.
- **General approach of the Final Regulations:**
 - The Final Regulations present two general alternative computational regimes for taxpayers:
 - One computational regime is the default FEET method, which generally would require taxpayers to maintain more complex data but potentially would provide taxpayers with more control over the timing of recognizing section 987 gains and losses and the amount of such gain or loss recognized. However, the default FEET method would result in section 987 gain or loss being significantly different than amounts reflected on financial statements as currency translation adjustments (CTA).
 - Another computational regime involves making a CRE. This regime generally would require taxpayers to maintain more simplified data, but potentially would provide taxpayers with less control over the timing of recognizing section 987 gains and losses and the amount of such gain or loss recognized.

² Treas Reg. § 1.987-15(a)(1).

- The default FEED method retains the distinction between marked and historic items and the need to track historic rates. Such method also requires a full tax basis balance sheet (TBBS) for each QBU.
- The CRE, on the other hand, eliminates the need to use historic rates in any computation. Further, taxpayers that make a CRE can compute section 987 gain or loss using either the QBU's TBBS or a new alternative methodology that is very similar to the earnings and capital approach under the 1991 proposed regulations (the "quasi-1991 method"). Finally, the CRE allows taxpayers to rely on the 2024 Proposed Regulations to make yet another simplifying election for certain routine disregarded transfers between the tax owner and the Section 987 QBU.
- However, the CRE generally requires certain section 987 losses to be suspended and recognized only to the extent of certain section 987 gains. Nonetheless, if a taxpayer makes an ARE, which generally requires the taxpayer to recognize all section 987 gain or loss every year, the suspended loss rules and loss deferral rules generally do not apply (with some exceptions).
- While suspended losses are expected to be recognized at some point in the future, some suspended losses may be lost permanently (*e.g.*, in inbound section 381 transactions or section 331 transactions).
- The Final Regulations retain and modify the deferral event and outbound loss rules (which have been effective since 2016) and apply the suspended loss rules with respect to outbound loss event rules.
- Rules for section 988 transactions largely remain the same as they are under current law; thus, section 988 transactions are determined based on the QBU's functional currency and section 988 gain or loss is computed based on the QBU's functional currency. A new section 988 mark-to-market election is now available for section 987 QBUs.
- Final Regulations address coordination with certain consolidated return rules.
- Final Regulations clarify rules for sourcing and characterizing section 987 gains and losses.
- Final Regulations provide special rules for transactions treated as net investment hedges for financial accounting purposes.
- Final Regulations provide select rules for partnerships and insurance companies.

Transition

- **Fresh start method replaced:**
 - The "fresh start" transition method provided in the final section 987 regulations issued in 2016³ (the "2016 Final Regulations") is no longer applicable under the Final Regulations.

³ The fresh start transition method, described in Treas. Reg. § 1.987-10, involves a deemed termination of a Section 987 QBU on the day before the transition date; however, no section 987 gain or loss would be recognized and all items on the balance sheet on the transition date would be translated using historic rates.

- **Options for preserving pre-transition section 987 gains and losses:**
 - For a taxpayer that chooses not to amortize the pre-transition section 987 gains and losses and that does not make a CRE or an ARE for its first taxable year the Final Regulations apply:
 - Pre-transition section 987 gains are considered “unrecognized section 987 gains” and are added to the post-transition pool of section 987 gain or loss, essentially creating a beginning section 987 gain balance for the Section 987 QBU on the date of transition to be recognized under the regular rules in the Final Regulations.⁴
 - However, pre-transition section 987 losses are considered “suspended section 987 losses” and are subject to the suspended loss rules discussed below.⁵
 - Pre-transition section 987 gain and loss are computed on a QBU-by-QBU basis and the gross section 987 gain and loss amounts are subject to the above rules. There is no netting within a tax owner.
 - If the taxpayer (that chooses not to amortize the pre-transition section 987 gains and losses) makes a CRE, but not an ARE, for its first taxable year the Final Regulations apply:
 - Pre-transition section 987 losses are not suspended but are considered “unrecognized section 987 losses” and (similarly to pre-transition section 987 gains) are added to the post-transition pool of section 987 gain or loss, essentially creating a beginning section 987 loss balance for the Section 987 QBU on the date of transition to be recognized under the rules in the Final Regulations.⁶
 - Pre-transition section 987 gain and loss are computed on a QBU-by-QBU basis and the gross section 987 gain and loss amounts are subject to the above rules. There is no netting within a tax owner.
 - **Amortization election:**
 - Under this election, pre-transition section 987 gains and losses can be recognized ratably over the 10-year period starting with the transition date.⁷ This election can be made regardless of whether the taxpayer makes a CRE, ARE, or both.
 - However, if a taxpayer makes this election, and the relevant QBU owner is engaged in an inbound or outbound section 381(a) transaction, any remaining unrecognized pre-transition gain of such owner is immediately recognized and any remaining unrecognized pre-transition loss of such owner is suspended under the suspended loss rules discussed below.⁸

⁴ Treas. Reg. § 1.987-10(e)(5)(i)(A).

⁵ Treas. Reg. § 1.987-10(e)(5)(i)(B)(1).

⁶ Treas. Reg. § 1.987-10(e)(5)(i)(B)(2).

⁷ Treas. Reg. § 1.987-10(e)(5)(ii).

⁸ Treas. Reg. § 1.987-10(e)(5)(ii)(B).

- As discussed further below, in an inbound section 381(a) transaction, any suspended pre-transition loss not used under the loss-to-the-extent-of-gain rule (also discussed below) does not carry over and thus is permanently eliminated.⁹

Observations:

In assessing whether to make a CRE or an ARE, taxpayers should consider the impact to pre-transition section 987 losses, especially with respect to character and sourcing.

- **Computation of pre-transition section 987 gains and losses:**
 - Upon the transition to the Final Regulations, a taxpayer computes pre-transition section 987 gains or losses computed under its existing method if its existing method is an “eligible pre-transition method.”¹⁰
 - **Earnings and capital method** (*i.e.*, the method under the proposed section 987 regulations issued in 1991 (the “1991 Proposed Regulations”)) is an eligible pre-transition method:
 - If the taxpayer has applied the earnings and capital method in a reasonable manner, the taxpayer would compute pre-transition section 987 gain or loss based on such method.¹¹
 - **Earnings-only method that meets the requirement of Treas. Reg. § 1.987-10(e)(4)(ii) is an eligible pre-transition method:**
 - If the taxpayer has applied the earnings-only method that produces the same total amount of income over the life of the owner of a section 987 QBU as the earnings and capital method, the taxpayer generally would compute pre-transition section 987 gain or loss based on such method.¹²
 - If a taxpayer does not make a CRE in the first taxable year the Final Regulations apply, the taxpayer would compute pre-transition section 987 gain or loss with respect to the earnings pool and a portion of the capital pool represented by marked assets. Special rules are provided for translating historic items on the balance sheet on the transition date to further preserve historic rates related to capital.¹³
 - If a taxpayer makes a CRE, the taxpayer would compute pre-transition section 987 gain or loss with respect to both the earnings pool and the capital pool.¹⁴
 - **Earnings-only method that does not meet the requirements of Treas. Reg. § 1.987-10(e)(4)(ii) can be an eligible pre-transition method:**

⁹ Treas. Reg. § 1.987-10(e)(5)(ii)(B)(2).

¹⁰ Treas. Reg. § 1.987-10(e)(4).

¹¹ Treas. Reg. § 1.987-10(e)(4)(i).

¹² Treas. Reg. § 1.987-10(e)(4)(ii).

¹³ Treas. Reg. § 1.987-10(d)(3)(ii).

¹⁴ Treas. Reg. § 1.987-10(e)(2)(i).

- If the taxpayer has applied the earnings only method that does not satisfy the requirements of Treas. Reg. § 1.987-10(e)(4)(ii), but otherwise satisfies the requirements of Treas. Reg. § 1.987-10(e)(4)(iii), the taxpayer can use such earnings-only method in computing its pre-transition section 987 gain or loss, provided that certain consistency and other requirements are met.
 - **Full-deferral method:**
 - A method to defer recognition of section 987 gain or loss until the termination of the QBU is not considered to be a reasonable method.¹⁵
 - **Taxpayers that did not use an eligible pre-transition method:**
 - Taxpayers must compute pre-transition section 987 gains or losses using a simplified approach provided in the Final Regulations. Specifically, the pre-transition section 987 gain or loss in such case would be a section 987 gain or loss computed under the Final Regulations using the annual TBBS of the Section 987 QBU (but treating all items as marked and simplifying the computation steps) reduced by any section 987 gain or loss actually recognized in the past with respect to the QBU (“the simplified FEEP method”).¹⁶ Note that the alternative calculation of QBU net value approach (the “quasi-1991 method”) under Treas. Reg. § 1.987-4 can be used in lieu of the annual TBBS of the QBU.
 - **The Final Regulations provide a few changes to the definition of an eligible pre-transition method:**
 - The expanded definition for eligible pre-transition method addresses errors in the computations in prior years (including treatment of disregarded transactions), as well as the consistent use of practices that may not have been correct.¹⁷
 - The simplified FEEP method for computing pre-transition gain or loss begins for taxpayers’ taxable year beginning on or after September 7, 2006. As a result, pre-transition section 987 computations generally need to be performed only for taxable years beginning on or after such date.¹⁸
 - A new *de minimis* election was adopted for qualified small businesses. By making the election, eligible taxpayers would treat their pre-transition section 987 gain or loss as equal to zero for QBUs that meet the provided QBU and owner thresholds.¹⁹

¹⁵ Treas. Reg. § 1.987-10(e)(4)(vi).

¹⁶ Treas. Reg. § 1.987-10(e)(3).

¹⁷ Treas. Reg. § 1.987-10(e)(4).

¹⁸ Treas. Reg. § 1.987-10(e)(3)(ii)(A).

¹⁹ Treas. Reg. § 1.987-10(e)(7).

Observations:

- Taxpayers should examine whether their current section 987 computational methodology qualifies as an “eligible pre-transition method” that has been reasonably and consistently applied. Note that 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, if applicable.
- Judgment calls may be needed in assessing errors and consistent practices in the application of a taxpayer’s previous method.
- Taxpayers that have not computed section 987 gain or loss in the past under an eligible pre-transition method must compute the pre-transition section 987 gain or loss under the simplified FEEP method. The “quasi-1991 method” approach provided under Treas. Reg. § 1.987-4(e)(2)(iii) can be used, which may reduce the burden of assembling a full TBBS for prior years.

- **Terminating QBUs:**

- Under the Final Regulations, a terminating QBU is subject to the Final Regulations (including the suspended loss rules, addressed below), which would apply immediately before the section 987 QBU terminates.²⁰ The transition date is the day after the termination date.²¹
- Until the generally applicable transition date described in Treas. Reg. § 1.987-15(a)(1), (b) or (c), the owner of the terminating QBU must apply the Final 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 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 as described in Treas. Reg. § 1.987 – 6(b)(2)(i)(C)).
- The transition rules of Treas. Reg. § 1.987-10 are applied immediately before the termination, and the consequences of the termination are determined under the Final Regulations.
- A terminating QBU is defined as a Section 987 QBU that terminates on or after November 9, 2023, or terminates as a result of an entity classification election on Form 8832 that is filed on or after November 9, 2023 but is effective before November 9, 2023, if, when the section 987 QBU terminates, neither the Final Regulations nor the 2016 Final Regulations and final section 987 regulations issued in 2019 (the “2019 Final Regulations”) would apply with respect to the section 987 QBU but for Treas. Reg. § 1.987 – 15(a)(2).²²
- The Final Regulations provide that the amortization election, if made, would apply to deferred section 987 gains and losses or suspended section 987 losses with respect to a terminating QBU.²³

²⁰ Treas. Reg. § 1.987-15(a)(2).

²¹ Treas. Reg. § 1.987-10(c)(2)(i).

²² Treas. Reg. § 1.987-1(h).

²³ Treas. Reg. § 1.987-10(e)(5)(ii)(C).

- The Final Regulations allow for section 987 gain recognized in a pre-transition year to be apportioned under the Final Regulations so that a section 987 loss arising as a result of a terminating QBU can offset such gain.

Observations:

- Taxpayers should carefully consider potential section 987 effects with respect to any restructurings or entity classification elections made on or after November 9, 2023, where a Section 987 QBU potentially is terminated (because any section 987 loss of a terminating QBU may be subject to the suspended loss rules), and where the section 987 gain or loss are subject to new sourcing and characterization rules.
- Taxpayers should carefully consider the impact of the amortization election with respect to section 987 suspended losses associated with terminating QBUs prior to the transition date of the Final Regulations.

Scope

- **Covered persons:**
 - Any individual or corporation is subject to the Final Regulations, except foreign corporations that are not CFCs, CFCs without a US shareholder with section 958(a) ownership, and foreign individuals.²⁴ The Final Regulations provide that certain provisions of the Final Regulations do not apply to partnerships and S corporations.²⁵ See the Partnership section below for a more detailed discussion of which select rules apply to partnerships.
 - Generally, the Final Regulations do not apply to trusts and estates.

Observations:

Banks, insurance companies, RICs, REITs, and other taxpayers that were excluded from some of the prior guidance (*e.g.*, the 2016 Final Regulations) are in scope of the Final Regulations.

- **Definition of QBU and Eligible QBU:**
 - **QBU under section 989:** Section 989 and associated regulations provide a definition of a QBU for purposes broader than section 987; thus, QBUs may include certain *per se* QBUs (*e.g.*, corporations) as well as activity-based QBUs. The Final Regulations remove partnership as a *per se* QBU. The preamble provides that “[p]ending future guidance, taxpayers must apply sections 987 and 989(a) with respect to partnerships using a reasonable method consistent with the statute.”²⁶
 - **QBU for purposes of section 987:** Under the Final Regulations, a corporation, partnership, trust, estate, or disregarded entity is not itself a QBU for purposes of section 987, but the activities of such entity may be a QBU.

²⁴ Treas. Reg. § 1.987-1(b)(1).

²⁵ Treas. Reg. § 1.987-7(b).

²⁶ T.D.10016, 89 Fed. Reg. 100138, 100151 (Preamble).

- If a corporation is solely engaged in activities that constitute a trade or business within the meaning of Treas. Reg. § 1.989(a)-1(b)(2)(ii)(A), and the corporation maintains only one set of books and records, the activities (but not the corporation) are a QBU.²⁷
- An Eligible QBU is defined as a QBU (as defined for purposes of section 987) that is not subject to the US DASTM rules under Treas. Reg. § 1.985-3. Recall that a Section 987 QBU is an Eligible QBU that has a different functional currency than that of its owner.

Observation:

- Because a corporation can have an Eligible QBU regardless of whether such Eligible QBU is a Section 987 QBU to the corporation, the suspended loss rules can apply to a trade or business of a corporation even if such trade or business does not constitute a Section 987 QBU.
- The removal of partnership as a *per se* QBU, read in conjunction with the preamble, seems to provide taxpayers with flexibility in how they treat a partnership for purposes of section 987 (and subpart J as a whole).

Computational methodology and elections

- **Default FEET method:**
 - As stated above, the Final Regulations present two alternative computational methodologies for taxpayers; one method is the default FEET method, and another method is the CRE.
 - The default FEET method retains the distinction between marked (monetary) and historic (non-monetary) items in computing taxable income, earnings and profits, section 987 gain or loss, and tax basis, and requires tracking of historic exchange rates for historic items. The default FEET method also requires full TBBS for each QBU that is maintained for every taxable year.
 - Marked items consist of cash, debt instruments, accounts receivable and payable, and currency derivatives attributable to the QBU.²⁸ Marked items also include short-term prepaid expenses and liabilities for unearned income, as well as certain items prevalent in the insurance industry (*e.g.*, reserves and separate account assets). All other assets or liabilities of a QBU are historic items.²⁹

²⁷ Treas. Reg. § 1.987-1(b)(4)(ii).

²⁸ Treas. Reg. § 1.987-1(d).

²⁹ Treas. Reg. § 1.987-1(e).

- A historic exchange rate generally means an average rate for the year in which the QBU acquires an item (including by transfer or deemed transfer to the QBU from owner).³⁰ With respect to the historic items on the TBBS on the transition date, the historic rate is generally the spot rate on the date before the transition (except for certain cases involving taxpayers that had used the “earnings-only” method before transition).³¹
- In determining taxable income of a QBU under the default approach, taxpayers must use historic foreign exchange (FX) rates to translate certain deductions (*e.g.*, depreciation, amortization) and basis recovery (*e.g.*, basis in property sold), and current yearly average FX rates to translate the remaining items.³² Special rules apply to sales of inventory.³³
- To compute section 987 gain or loss under the default approach, taxpayers must use a multi-step process that consists of comparing the net value of the QBU (expressed in the owner’s functional currency) at the end of a tax year to the net value at the end of the prior tax year and making adjustments for amounts such as taxable income, transfers, etc., in order to isolate the change in net value attributable solely to exchange rate movement during the year with respect to marked items.³⁴
- To determine the net value of a QBU, taxpayers must use the TBBS of the QBU, translated to the owner’s currency. In translating the TBBS of the QBU (and the transfers of items to or from the QBU), taxpayers must use historic exchange rates for historic items and spot exchange rates for marked items (*i.e.*, year-end spot rates for year-end TBBS and applicable daily spot rates for transfers of marked items).³⁵
- The multi-step process accounts for the impact of income and expenses that affect the income statement but not the balance sheet and vice versa.³⁶ In addition, a catch-all step (“Step 10”) requires a computation of the residual change in value of the QBU measured in the QBU’s functional currency unaccounted for by already-identified earnings, transfers, and adjustments.³⁷
- Section 987 gain or loss is generally recognized upon a remittance from, or a termination of, a QBU (subject to the deferral rules and certain suspended loss rules discussed below).³⁸ Generally, under the default FEET method, section 987 losses recognized on a regular remittance are not subject to loss suspension rules.

³⁰ Treas. Reg. § 1.987-1(c)(3).

³¹ Treas. Reg. § 1.987-10(d)(3).

³² Treas. Reg. §§ 1.987-3, -1(c).

³³ Treas. Reg. § 1.987-3(c)(3).

³⁴ See Treas. Reg. § 1.987-4.

³⁵ Treas. Reg. §§ 1.987-4, -1(c).

³⁶ Treas. Reg. § 1.987-4(d)(1) Steps 7, 8, 9.

³⁷ Treas. Reg. § 1.987-4(d)(1) Step 10.

³⁸ Treas. Reg. § 1.987-5.

- The section 987 gain or loss recognized on a remittance is based on net accumulated unrecognized section 987 gain or loss and a remittance proportion, which in turn is determined based on net transfer from the QBU to the owner (the numerator in the remittance proportion ratio) and tax basis in the gross assets of the QBU (the denominator in the remittance proportion ratio).
- Transfers to or from the QBU generally consist of disregarded transfers of (regarded) property or liabilities between a QBU and the owner (or other QBUs of the owner).³⁹ While the default FEED method requires tracking of individual transfers (and corresponding exchange rates) for purposes of determining overall section 987 gain or loss, the Final Regulations provide two alternatives for determining a remittance, one alternative requiring tracking of transfers and one alternative that is based on the changes in net value not attributable to income or deductions.⁴⁰
- To translate basis in items transferred from the QBU under the default approach, taxpayers must use historic exchange rates for historic items and spot exchange rates for marked items.⁴¹
- **The CRE:**
 - The CRE simplifies the computations under section 987 in several ways.
 - First, the CRE eliminates the need to use historic rates in any computation.⁴² Thus, taxable income is determined using the average exchange rate for the tax year, and the TBBS is translated using the spot rate at tax year end.
 - Next, in computing section 987 gain or loss, the multi-step process described above is simplified by eliminating certain steps and only focusing on the net value comparison, adjustments for transfers of assets and liabilities, and the residual adjustment (or Step 10, which is also simplified).⁴³
 - Further, for purposes of computing the net value of the QBU, two alternative approaches are allowed: the TBBS-based approach and the quasi-1991 method.
 - As stated above, in lieu of using the TBBS-based approach, taxpayers that make a CRE can compute section 987 gain or loss using a methodology that is very similar to how the equity pool is computed under the earnings and capital approach in the 1991 Proposed Regulations. Under the quasi-1991 method, the net value of a QBU is determined using the taxable income and transfers to and from the QBU in prior and current years.
 - Under the quasi-1991 method, the requirement to maintain a TBBS is significantly curtailed. Practically speaking, one would need to have the initial TBBS (*e.g.*, initial transfer to the QBU upon formation, or TBBS of the QBU when it transitioned to the Final Regulations or when the CRE election was made if it

³⁹ Treas. Reg. § 1.987-2(c).

⁴⁰ Treas. Reg. § 1.987-5.

⁴¹ Treas. Reg. §§ 1.987-2(d) & -5(f).

⁴² Treas. Reg. § 1.987-1(d)(2).

⁴³ Treas. Reg. § 1.987-4(d).

was made after the first year of the Final Regulations). Taxpayers also would need to know the tax basis in subsequent transfers as well as the tax basis in the gross assets of the QBU for purposes of computing the remittance proportion. (The latter is not relevant if the ARE is made).

- Making the CRE also allows taxpayers to rely on the 2024 Proposed Regulations to make the recurring transfer group election (RTGE) for routine disregarded transfers, as further described below.⁴⁴
- The CRE does come at a cost. In contrast to the default FEEP method, the CRE generally requires section 987 losses that otherwise would be recognized in a given year to be suspended and recognized only to the extent of gains.⁴⁵ The application of the loss suspension and loss-to-the-extent-of-gain rules is discussed further below. The loss suspension can be remedied by making the ARE, also discussed below.
- **Annual recognition election:**
 - The ARE allows taxpayers to recognize all unrecognized section 987 gain or loss on an annual basis.⁴⁶
 - If the ARE is made, any previously unrecognized or deferred section 987 gain is recognized and any previously unrecognized or deferred section 987 loss becomes suspended loss if either such loss is above \$5 million or if there is a CRE in place at any point before (*i.e.*, “pre-ARE losses”).⁴⁷
 - Making the ARE generally turns off the suspended loss rules that otherwise would apply due to the CRE election.⁴⁸
 - Notwithstanding the ARE, the suspended loss rules would continue to apply to the suspended pre-transition losses or pre-ARE losses.⁴⁹ Such losses continue to be recognized under the modified loss-to-the-extent-of-gain rules discussed below. Recall that making an ARE (while also making a CRE) results in the suspension of pre-transition losses that are not amortized.
 - The ARE also turns off the deferral event rules and outbound loss rules (that convert the outbound loss into suspended loss).⁵⁰
 - Regardless of whether the CRE is made, the ARE requires taxpayers to use current FX rates for all items in computing taxable income.⁵¹ However, unlike the CRE, the ARE still requires application of historic rates to historic items in computing section 987 gain or loss and translating basis upon transfers.⁵² In such case, any difference between using the current FX rates for taxable income and historic FX rates for FEEP is captured as additional section 987 gain or loss.

⁴⁴ Treas. Reg. § 1.987-2(f).

⁴⁵ Treas. Reg. § 1.987-11(c)(1).

⁴⁶ Treas. Reg. § 1.987-5(b)(2).

⁴⁷ Treas. Reg. § 1.987-11(d)(1).

⁴⁸ Treas. Reg. § 1.987-11(c)(1).

⁴⁹ Recall also that an election is available in which a taxpayer may amortize pre-transition section 987 losses.

⁵⁰ Treas. Reg. §§ 1.987-12(a)(2)(i), -13(h).

⁵¹ Treas. Reg. § 1.987-3(c)(2).

⁵² Treas. Reg. §§ 1.987-1(c)(3), -2(d)(2), -4(d)&(e)(2)(ii), -5(f)(3).

- Finally, the ARE alleviates the need to compute remittances or determine the tax basis in gross assets at year end.
- **Recurring transfer group election:**
 - The 2024 Proposed Regulations permit taxpayers to make an election to simplify tracking of certain disregarded transfers. Specifically, the recurring transfer group election or RTGE would apply to disregarded transactions involving payments for services, rents, royalties, and certain sales.
 - The RTGE is available only to taxpayers that make the CRE. Instead of tracking and translating each individual transfer, taxpayers that make the CRE (and use a TBBS-based approach to computing net value of a QBU) can derive the net amount of such transfers using a provided formula and translate the net amount of such transfers using an average rate for the year. Taxpayers that make the CRE and use the quasi-1991 method to compute the net value of the QBU still must track all disregarded transfers in QBU's functional currency but can translate such transfers as a lump sum using the average rate for the year.

Observations:

- The Final Regulations contain detailed rules for attributing items to the books of a QBU (including anti-abuse rules) and, for purposes of sections 987 and 988 exclude certain stock and partnership interests from the assets of the QBU, and certain debt used to acquire such stock or interests from the liabilities of the QBU.⁵³
- Using the default FEEP method would require taxpayers to change the way taxable income is computed (for all tax purposes) not just the way section 987 gain or loss is computed. Under this approach, taxpayers will be required to track the year in which the QBU acquired a particular historic item or placed it in service and to calculate depreciation, amortization, and basis recovery on an item-by-item basis. Accounting for inventory sales also would require complex computations.
- Making a CRE generally yields the same amount of section 987 gain or loss over the life of the QBU as using the 1991 Proposed Regulations except in cases of QBUs that own stock or partnership interests. Further, a CRE allows for a quasi-1991 method that involves a similar process and similar data requirements as the 1991 Proposed Regulations. Whether or not the CRE increases or decreases the exposure to section 987 gain or loss (compared to the default FEEP method) depends on the mix of assets and liabilities (historic vs. marked).
- The quasi-1991 method generally is expected to appeal to taxpayers that prefer to reduce the burden of tracking TBBS, and the TBBS-based method generally would appeal to taxpayers that prefer to reduce the burden of tracking disregarded transfers.

⁵³ Treas. Reg. §§ 1.987-1(c)(3), -2(d)(2), -4(d)&(e)(2)(ii), -5(f)(3).

Observations: *(continued)*

- Regardless of the computational method used (default FEEP method, CRE with TBBS, or CRE with quasi-1991 method), any and all items must be adjusted for US federal income tax principles, and some tracking of disregarded transactions will be required – *i.e.*, taxable income of a QBU (and owner) should be adjusted to eliminate disregarded income and expense, the TBBS of a QBU should include only regarded items, and transfers to or from the QBU should include disregarded transfers of regarded items.
- Even if a CRE is not made, the ARE should be considered if the taxpayer wishes to simplify the computations of taxable income. In some cases, where the net marked assets or liabilities are not significant, the annual volatility of section 987 gain or loss may be a palatable trade-off for being able to compute taxable income without using historic rates.
- The Final Regulations generally require consistency in making all section 987 elections for all related parties. The Final Regulations provide detailed procedures for making and revoking the elections, including a five-year limitation on being able to revoke (or make again) certain elections without the consent of the IRS. The Final Regulations provide more favorable rules for making the elections in the first year to which Final Regulations apply, with more restrictive elections for elections made later. Elections made for the first year in which the Final Regulations apply must be made on the tax return filed for such first year.
- Taxpayers will need to carefully model and analyze the impacts of the CRE and the ARE, given that the election or revocation of such elections generally will be binding for five taxable years.

Partnerships

- Subject to the exceptions noted below, the Final Regulations generally do not apply to partnerships or QBUs owned by partnerships, and the transition rules do not apply to such QBUs.
- Taxpayers must apply sections 987 and 989(a) to partnerships and eligible QBUs owned by partnerships in a reasonable manner using a consistent method from year to year with respect to a particular partnership or eligible QBU.⁵⁴ Further, all members of the same controlled group must apply the same method consistently with respect to a particular partnership or eligible QBU owned by the partnership.⁵⁵
- The section 989 regulations no longer state that partnerships are *per se* QBUs and no longer address section 987 aggregate partnerships.
- According to the preamble, a reasonable method for applying section 987 and 989(a) may include using an entity approach (*i.e.*, treating a partnership as a *per se* QBU and/or an owner of eligible QBUs), an aggregate approach (treating partners as owners of eligible QBUs owned by a partnership), and a hybrid approach described in the 2023 Proposed Regulations.⁵⁶

⁵⁴ Treas. Reg. § 1.987-7(b).

⁵⁵ Treas. Reg. § 1.987-7(b).

⁵⁶ .D.10016, 89 Fed. Reg. 100138, 100151 (Preamble).

- Certain portions of the 2024 Final Regulations will apply to partnerships treated by taxpayers as QBUs subject to section 987 (“Partnership QBU”)⁵⁷ or eligible QBUs owned by partnerships treated as QBUs subject to section 987 (“Partnership-Owned QBUs”)⁵⁸:
 - Applicability provisions (including applicability to terminating QBUs, *i.e.*, for QBUs terminating after November 8, 2023 and before the applicability of the 2024 Final Regulations, the portions described below would apply early);⁵⁹
 - Sourcing and characterization rules;⁶⁰
 - The deferral rules and loss suspension rules, subject to modifications;⁶¹
 - The ARE;⁶²
 - Section 988 mark-to-market election,⁶³ and
 - Certain reporting requirements.⁶⁴
- Importantly, any section 987 loss realized with respect to a Partnership QBU or Partnership-Owned QBU that otherwise would be recognized (after the application of the deferral rules) would become a suspended loss.⁶⁵ With respect to Partnership QBUs, this rule applies only to a partnership if at least 95% of interests in such partnership are owned by related persons.⁶⁶
- There are three exceptions to applying this loss suspension rule in the partnership context: (i) if a taxpayer applies a FEEP-like approach to a Partnership-Owned QBU (differentiating historic and marked items); (ii) if a taxpayer makes an ARE; (iii) if the loss meets the *de minimis* exception for suspended losses.⁶⁷
- The suspended losses generally would be recognized under the loss-to-the-extent-of-gain rules and upon certain terminations.⁶⁸ For Partnership QBUs that do not have a trade or business, the suspended losses can only be recognized under the loss-to-the-extent-of-gain rule.⁶⁹
- If a partner also owns section 987 QBUs other than Partnership QBUs or Partnership-Owned QBUs, the partner can commingle the suspended losses and gains of all its section 987 QBUs in a given recognition grouping.⁷⁰

⁵⁷ Treas. Reg. § 1.987-7(c)(1)(i).

⁵⁸ Treas. Reg. § 1.987-7(c)(1)(ii).

⁵⁹ Treas. Reg. § 1.987-7(c)(2).

⁶⁰ Treas. Reg. § 1.987-7(c)(2)(i).

⁶¹ Treas. Reg. § 1.987-7(c)(2)(i).

⁶² Treas. Reg. § 1.987-7(c)(2)(ii).

⁶³ Treas. Reg. § 1.987-7(c)(2)(iii).

⁶⁴ Treas. Reg. § 1.987-10(k)(2)(i).

⁶⁵ Treas. Reg. § 1.987-7(d)(1)(ii).

⁶⁶ Treas. Reg. § 1.987-7(d)(1)(ii)(B).

⁶⁷ Treas. Reg. § 1.987-7(d)(2).

⁶⁸ Treas. Reg. § 1.987-7(d)(3)(i).

⁶⁹ Treas. Reg. § 1.987-7(d)(3)(ii).

⁷⁰ Treas. Reg. § 1.987-7(d)(3)(iii).

Observations:

- There appears to be flexibility in whether to treat a partnership as a *per se* QBU, and whether to apply an entity or aggregate approach (or a hybrid approach) to a partnership or QBUs owned by a partnership. These choices should be considered carefully along with the broader application of currency rules (including functional currency, section 988, methods of accounting, etc.).
- There do not appear to be clear rules for transitioning onto a reasonable method taxpayers that might not have been applying section 987 using a reasonable method.
- For taxpayers making the ARE for Partnership QBUs or Partnership-Owned QBUs, the losses existing prior to making the ARE appear to become suspended losses (in other words, the losses accumulated prior to making the ARE are not accelerated via the ARE).
- The Final Regulations confirm that the basis in a partnership interest should be adjusted for section 987 gains or losses that are recognized, deferred, or suspended.

Insurance industry

The preamble to the Final Regulations provides a detailed discussion of the government's thought process in addressing certain questions and concerns raised by insurance companies. The Final Regulations treat insurance reserves and separate account assets as marked items; in addition, the preamble clarifies the treatment of certain other items.

Consolidated group rules

- Deemed transactions between members of a consolidated group:
 - To facilitate single-entity treatment, the Final Regulations treat a transaction between the Section 987 QBU of one member and any other member of the same consolidated group (including a Section 987 QBU of that other member) as a combination of (i) an intercompany transaction between the members, and (ii) a transfer between each Section 987 QBU and its tax owner (see Treas. Reg. § 1.987-2(c)(2)(ii)) as necessary to take into account the effect of the transaction on the assets and liabilities of each Section 987 QBU.⁷¹
 - For example, if member A makes a EUR-denominated loan to the Section 987 QBU of member B, it is treated as if member A made a EUR-denominated loan to member B followed by a contribution of the EUR cash from the loan to its Section 987 QBU. A payment of interest or principal from the Section 987 QBU is treated as a transfer of EUR cash from the Section 987 QBU to member B, followed by a payment from member B to member A under the EUR-denominated loan.

⁷¹ Treas. Reg. § 1.1502-13(j)(9).

Observation:

- It is unclear how a taxpayer would transition to this construct if the taxpayer has existing loans between a Section 987 QBU owned by one member and any other member of the same consolidated group (including a Section 987 QBU of that other member).
- These rules may create complexity in accounting for derivatives between Section 987 QBUs and other members of the consolidated group.

Suspended loss rules if a CRE is made or revoked or if taxpayer has pre-transition section 987 loss

- Suspended loss and the loss-to-the-extent-of-gain rule:
 - The Final Regulations continue to include rules suspending the recognition of section 987 losses with some modifications.
 - The suspended loss rules can apply to the following scenarios: (i) pre-transition section 987 loss that is not subject to the amortization election (however, any pre-transition loss is not considered to be a suspended loss if the taxpayers only makes a CRE); (ii) pre-transition section 987 loss that is subject to the amortization election, but is accelerated under certain section 381(a) transactions; (iii) section 987 loss realized when a CRE is in effect and an ARE is not in effect; (iv) section 987 loss that is treated as suspended loss in an outbound loss event; and (v) making an ARE where there was a CRE for the prior year or a CRE was not in effect, but the net unrecognized and deferred section 987 loss of a tax owner exceeds the sum of the owner's net accumulated unrecognized section 987 gain and deferred section 987 gain by more than \$5 million.
 - The suspended loss rules incorporate the "outbound loss event" rules that were formerly part of the Treas. Reg. § 1.987-12 under the 2019 Final Regulations regarding deferral events.⁷² The Final Regulations provide that outbound section 987 loss should be treated as suspended section 987 loss rather than adjusting the basis of stock (or recognizing it when the owner of the Section 987 QBU and the related foreign person cease to be related). This change was intended to permit the recognition of outbound loss to the extent the owner recognizes section 987 gain in the same recognition grouping.
 - **CRE in effect with no ARE:** If a CRE is in effect and an ARE is not in effect, the Final Regulations generally would suspend the recognition of section 987 loss as a result of remittance (including a deemed remittance from the termination of the QBU) until a taxable year in which an equal or greater amount of section 987 gain in the same "recognition grouping"⁷³ is recognized or until the occurrence of certain recognition events (the "loss-to-the-extent-of-gain" rule).⁷⁴

⁷² Treas. Reg. § 1.987-13(h).

⁷³ Treas. Reg. § 1.987-11(f). In general, section 987 gain and suspended section 987 loss are in the same recognition grouping if they are both initially assigned to US source income or to foreign source income in the same CFC income grouping (tested income, Subpart F groupings, or ECI).

⁷⁴ Treas. Reg. § 1.987-11(c); Treas. Reg. §§ 1.987-11(e)(1) and (f).

- Under the loss-to-the-extent-of-gain rule, a tax owner only recognizes suspended section 987 loss to the extent of the sum of the current year gain and a new look-back gain amount, not to exceed the owner's total cumulative suspended section 987 loss in the recognition grouping.⁷⁵ The Final Regulations allow taxpayers to include the look-back gain amount, representing the net section 987 gain over the look-back period, which generally is limited to the three preceding post-transition taxable years.⁷⁶
 - Moreover, the Final Regulations include a new *de minimis* rule in this context. Loss suspension does not apply to a controlled group's tax owner if the total amount of unrecognized section 987 loss for a taxable year for the tax owner and all members of the tax owner's controlled group does not exceed the lesser of \$3 million or 2% of the total gross income of the owner's controlled group.⁷⁷
 - The suspended loss rules apply at the owner level to the aggregate of the section 987 gains and losses.⁷⁸ All members of a consolidated group are treated as a single owner.⁷⁹ However, the Final Regulations include a new separate return limitation year (SRLY) loss limitation rule affecting the application of the loss-to-the-extent-of-gain rule when a consolidated group member joins the group with SRLY section 987 losses.⁸⁰
- **CRE and ARE both in effect:** If the taxpayer makes both a CRE and an ARE, the suspended loss rule does not apply to net unrecognized section 987 loss accrued while the elections are in effect.⁸¹ However, the application of the loss-to-the-extent-of-gain rule can still apply to certain suspended losses even with the ARE (such as pre-transition section 987 losses without an amortization election that are considered suspended losses).
 - The loss-to-the-extent-of-gain rule applies by reference to the net cumulative amount of section 987 gain in each recognition grouping that is recognized by the taxpayer in the current year. Moreover, the look-back gain amount for taxpayers with both a CRE and ARE is computed based on an expanded lookback period that includes all prior taxable years in which both an ARE and CRE are in effect.⁸²
- **ARE made in a taxable year after the CRE is in effect:** The suspended loss rules may apply at the time an ARE is made.

⁷⁵ Treas. Reg. § 1.987-11(e)(3).

⁷⁶ Treas. Reg. § 1.987-11(e)(3)(ii).

⁷⁷ Treas. Reg. § 1.987-11(c)(2).

⁷⁸ Treas. Reg. § 1.987-11(e)(1).

⁷⁹ Treas. Reg. § 1.987-11(e)(6)(i).

⁸⁰ Treas. Reg. § 1.987-11(e)(6)(ii).

⁸¹ Treas. Reg. § 1.987-11(c).

⁸² Treas. Reg. § 1.987-11(e)(3)(iv)(B).

- At the beginning of the first taxable year for which the ARE is made, net unrecognized section 987 loss and deferred section 987 loss are converted into *suspended loss* if: (i) a CRE was in effect for the immediately preceding taxable year, or (ii) the sum of the owner's net accumulated section 987 loss plus its deferred section 987 loss exceed by more than \$5 million the sum of the owner's net accumulated section 987 gain plus its deferred section 987 gain.⁸³
 - **CRE is revoked in a taxable year:**
 - At the beginning of the first taxable year in which a CRE ceases to be in effect, net unrecognized section 987 loss and deferred section 987 loss are converted into suspended loss.⁸⁴
 - The Final Regulations provide successor rules that apply when a Section 987 QBU with suspended section 987 loss terminates. Under the successor rule, the suspended section 987 loss is not recognized in the taxable year of termination but instead becomes attributable to a "successor suspended loss QBU." A successor suspended loss QBU may include a corporation that has no Section 987 QBUs.⁸⁵
 - If a Section 987 QBU (or its successor) terminates without a successor, the original owner of the Section 987 QBU recognizes all of its suspended section 987 loss with respect to the Section 987 QBU (or its successor).⁸⁶ This generally is limited to situations where a Section 987 QBU's assets are sold to an unrelated party or the QBU ceases its business operations.
 - There is a complex set of rules addressing terminations of a section 987 QBU with suspended losses and transfers of QBUs to "successor suspended loss QBUs."
 - For example, suspended section 987 loss is lost when the owner of a Section 987 QBU liquidates in a transaction described in section 331.⁸⁷
 - Also, suspended section 987 loss is eliminated in an inbound liquidation or reorganization in a section 381(a) transaction.⁸⁸

Observations:

- Before making a CRE, a taxpayer should carefully consider and analyze the effects of the suspended loss rules, which apply whenever a CRE is made. The suspended loss rules generally suspend the recognition of section 987 loss on remittances, while the deferral event rules generally defer the recognition of section 987 loss on QBU terminations. In certain situations, a deferred section 987 loss can be converted to suspended loss.

⁸³ Treas. Reg. § 1.987-11(d)(1).

⁸⁴ Treas. Reg. § 1.987-11(d)(2).

⁸⁵ Treas. Reg. § 1.987-13(b)(1).

⁸⁶ Treas. Reg. §§ 1.987-13(b)(2) and (c)(2).

⁸⁷ Treas. Reg. § 1.987-13(f).

⁸⁸ Treas. Reg. § 1.987-13(g).

Observations: *(continued)*

- The suspended loss rules generally apply where the taxpayer has made a CRE but not an ARE. Taxpayers choosing to apply the simplicity of the CRE calculation approach should consider the impact of either suspension of current year section 987 losses or the volatility of recognizing all section 987 gains and losses annually with an ARE.
- Taxpayers should consider making the ARE at the time the CRE is made, as this will mitigate certain applications of the suspended loss rules. The combination of the ARE and the CRE could simplify the application of the section 987 regulations where a CRE is made.
- Transfers of suspended loss QBUs raise complicated technical issues and should be analyzed carefully on a case-by-case basis.

Changes to the deferral rules

- The Final Regulations contain rules that defer the recognition of section 987 gain or loss in connection with transactions where a section 987 QBU is transferred within the controlled group. The rules outlined below generally are consistent with the changes to the deferral rules outlined in the 2023 Regulations.
- ***De minimis* and other exceptions:**
 - One of the exceptions to these rules is a \$5 million *de minimis* exception. The Final Regulations provide that the \$5 million *de minimis* exception applies to the total deferred section 987 gain or loss that otherwise would be recognized by the owner in a single taxable year (*i.e.*, taking into account all QBUs of the tax owner).⁸⁹
 - In addition to the *de minimis* rule, the Final Regulations provide that Treas. Reg. § 1.987-12 does not apply to a termination of a Section 987 QBU in a taxable year in which an ARE is in effect.⁹⁰
- Deferral event rules: Minor changes have been made to the core of the deferral event rules including coordination with the suspended loss rules. Note that section 987 loss may be suspended with respect to a deferral event if a CRE is in force.⁹¹
- Outbound loss event rules: Under the 2016 Final Regulations, an outbound loss event from the transfer of QBU assets in a section 351 or 361 transaction results in non-recognition of any section 987 loss and, generally, that loss is reflected in the basis of the stock received in the transaction. The Final Regulations change this rule by: (i) removing outbound loss events from the deferral event rules of Treas. Reg. § 1.987-12 (and addressing such events in Treas. Reg. § 1.987-13 regarding the treatment of suspended section 987 loss upon terminations) and (ii) providing that outbound section 987 loss is treated as suspended section 987 loss, instead of being added to the basis of stock.⁹² As indicated

⁸⁹ Treas. Reg. § 1.987-12(a)(2)(ii).

⁹⁰ Treas. Reg. § 1.987-12(a)(2)(i).

⁹¹ Treas. Reg. § 1.987-11(c).

⁹² Treas. Reg. § 1.987-13(h).

above, this rule is intended to permit the recognition of outbound section 987 loss to the extent the owner recognizes section 987 gain in the same recognition grouping, as explained in the section of this alert discussing the suspended loss rules.

Observations:

- The deferral event rules apply whether or not a CRE is in effect.
- If an ARE is in effect, the deferral event rules do not apply. Thus, an ARE mitigates the complexity of both the suspended loss rules and the deferral event rules by simplifying the application of the Final Regulations.
- The deferral rules maintain a complex series of successor rules to track the deferred section 987 gain or loss. Moreover, the interaction of the suspended loss rules and the deferral event rules is challenging and requires careful analysis.

Source and character of section 987 gains and losses

- Section 987 gains and losses are considered ordinary in character.⁹³
With respect to sourcing:
 - A tax owner initially assigns section 987 gain or loss from a QBU to the statutory and residual groupings of income using the tax book value asset method of Treas. Reg. § 1.861-9(g) and Treas. Reg. § 1.861-9T(g). The relevant assets for the asset method only include assets properly attributable to the QBU under the Final Regulations.⁹⁴
 - For purposes of the initial assignment of section 987 gain or loss, the section 987 gain or loss is assigned after any reattribution of income to the foreign branch category under Treas. Reg. § 1.904-4(f)(2)(vi) and the reattribution of tested income under Treas. Reg. § 1.951A-2(c)(7)(ii)(B)(2).⁹⁵
 - The initial assignment rules apply for taxable years in which current section 987 gain or loss is recognized, the taxable year in which unrecognized section 987 loss becomes suspended loss, the taxable year in which unrecognized section 987 gain or loss becomes deferred gain or loss, and determining the source and character of pre-transition section 987 gains and losses.⁹⁶
 - Section 987 gain or loss for a CFC is reassigned after the initial assignment to account for the application of the high-tax exception for passive category income, the high-tax exception for subpart F income, and the GILTI high-tax exclusion. Moreover, any section 987 gain or loss for the current taxable year is then reassigned to the appropriate groupings, taking into consideration whether the exclusions above apply.⁹⁷

⁹³ Treas. Reg. § 1.987-6(a).

⁹⁴ Treas. Reg. § 1.987-6(b)(2)(i)(A).

⁹⁵ Treas. Reg. § 1.987-6(b)(2)(i)(B).

⁹⁶ Treas. Reg. § 1.987-6(b)(1).

⁹⁷ Treas. Reg. § 1.987-6(b)(2)(i)(B) and Treas. Reg. § 1.987-6(b)(2)(ii).

- The Final Regulations provide that section 987 gains or losses that are assigned to subpart F income groups are assigned to those particular subpart F income groups.⁹⁸ As a result, if a QBU's assets only generate foreign base company sales income, then any section 987 gain or loss of that QBU will be characterized as foreign base company sales income.
- Additionally, the Final Regulations provide a special election related to source and character determination. A taxpayer may elect to treat section 987 gain or loss assigned to any grouping of passive foreign personal holding company income as FX gains and losses not directly related to the business needs of the CFC under section 954(c)(1)(D) without regard to other CFC-level FX elections.⁹⁹
- The Final Regulations provide special rules for the interplay of section 987 gain and loss with the GILTI high-tax exclusion election. Section 987 gains and losses assigned to tentative tested income are considered a single tested income item that is separate from the CFC's other tested units and that is neither assigned to the section 987 QBU tested unit nor the CFC tested unit.¹⁰⁰ Moreover, the Final Regulations provide rules for the allocation and apportionment of foreign income tax to section 987 gain but only to the extent the foreign gross income is an item of currency gain or loss and the same events give rise to both the foreign gross income and section 987 gain or loss.¹⁰¹
- A taxpayer that uses an eligible method to determine its pre-transition section 987 gains and losses must apply the sourcing and character rules of the Final Regulations, even if the eligible pre-transition method employed by the taxpayer otherwise provides a sourcing and character rule.¹⁰²

Observations:

- The source and character rules are critical for the application of the pre-transition gains and losses, suspended loss and deferral rules in the Final Regulations. Suspended or deferred section 987 losses are only recognized by the tax owner to the extent future section 987 gains recognized by the tax owner have the same source and character as the suspended or deferred section 987 losses. As a result, taxpayers should develop processes to track each QBU owner's multiple groupings of suspended section 987 losses.
- Section 987 gain or loss under the Final Regulations remains in the same subpart F income grouping as the underlying QBU's assets. Taxpayers should assess whether it is prudent to elect to treat section 987 gain or loss that is allocated to foreign personal holding company income categories as section 988 gain/loss that does not satisfy the business needs exception.

⁹⁸ Treas. Reg. § 1.987-6(b)(2)(i).

⁹⁹ Treas. Reg. § 1.987-6(b)(2)(i)(C)(1).

¹⁰⁰ Treas. Reg. § 1.987-6(b)(iii).

¹⁰¹ Treas. Reg. § 1.987-6(b)(3).

¹⁰² Treas. Reg. § 1.987-10(h)(1).

Observations: *(continued)*

- Taxpayers should consider carefully modeling and analyzing the impact of making subpart F high-tax and GILTI high-tax exclusion elections, as the elections may significantly impact the assignment of current-year section 987 losses and the utilization of prior suspended section 987 losses. Given that section 987 continues to be treated in the Final Regulations as its own separate item of tested income and not assigned to any tested unit of the CFC and foreign tax generally will not be allocated or apportioned to section 987 gains, section 987 gains of a CFC are not likely to qualify for the GILTI high-tax exclusion and generally must be included in a taxpayer's GILTI calculation.

Net investment hedges with respect to a section 987 QBU

- A net investment hedge of a section 987 QBU is a hedging transaction (*i.e.*, a financial instrument or series of financial instruments) entered into by the owner of a section 987 QBU in the normal course of the owner's trade or business to manage all or part of the exchange rate risk with respect to the owner's net investment in a section 987 QBU.¹⁰³ The net investment hedge is a section 988 transaction to the owner while the exposure being hedged ultimately relates to the section 987 gain or loss generated by the QBU. Moreover, in order to qualify for this treatment, the taxpayer must have made a CRE and such hedge must be accounted for by the taxpayer using mark-to-market accounting.
- Under Treas. Reg. § 1.987-14(b)(2), if a taxpayer satisfies all of the requirements, section 988 loss on the transaction that operates as a net investment hedge reduces the unrecognized section 987 gain of the QBU for the taxable year (but not below zero) and section 988 gain on the hedging transaction reduces unrecognized section 987 loss of the QBU for the taxable year (but not below zero). In both cases, the section 988 loss and gain is not taken into account under section 988 (unless it exceeds zero). The amount of any hedging loss or gain that exceeds zero is taken into account under section 988.

Observations:

- This addition to the section 987 regulations adds flexibility and provides a mechanism for addressing the relationship of the section 988 gain or loss on the net investment hedge and the income derived from the net assets of the section 987 QBU being hedged.
- Taxpayers that opt for the simplicity of section 987 computations by making a CRE may be able to address the increased volatility and generally larger pools of unrecognized section 987 gains and losses each year by opting to use a US GAAP net investment hedge of their interest in a section 987 QBU to reduce this volatility.

¹⁰³ Treas. Reg. § 1.987-14(b)(1).

Section 988

- Under the Final Regulations, the amount of section 988 gain or loss of a section 987 QBU is determined solely by reference to the functional currency of the QBU (not the owner).¹⁰⁴ Thus, section 988 transactions denominated in the owner's functional currency generate section 988 gain or loss to a section 987 QBU in the same manner as other section 988 transactions denominated in a nonfunctional currency with respect to the QBU.
- The Final Regulations provide that a taxpayer may elect to recognize section 988 gain or loss with respect to a section 987 QBU on all section 988 transactions of the QBU using a mark-to-market method of accounting (with certain exceptions).¹⁰⁵ The section 988 mark-to-market election is subject to the same timing and consistency rules under Treas. Reg. § 1.987-1(g). This mark-to-market election is not the same as, or associated with, the election provided in Prop. Treas. Reg. § 1.988-7.
- The Final Regulations provide that a section 988 transaction of a section 987 QBU is a "marked item."¹⁰⁶
- The Final Regulations provide an anti-abuse rule with respect to a transaction that has 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.¹⁰⁷ Section 988 transactions are also subject to the general anti-avoidance rules set for in Treas. Reg. § 1.987-2.

Observations:

The final regulations regarding section 988 transactions vastly simplify the approach to applying section 988 at the section 987 QBU level when compared to the proposed regulations, which required section 988 gain or loss of a QBU to be calculated and determined by reference to the owner's functional currency.

Election considerations

- The Final Regulations require consistency and provide that a section 987 election made by the taxpayer's controlled group must apply to all members of the group.¹⁰⁸
- In general, all section 987 elections require the consent of the IRS to make or revoke such elections.¹⁰⁹
- However, the Final Regulations clarify that the CRE, ARE, and mark-to-market election may be made or revoked for any taxable year generally without the consent of the IRS. However, once a CRE, ARE, or mark-to-market election is made, generally such election may not be revoked for 60 months without the IRS consent. Once a CRE, ARE, or mark-to-market election is revoked, the taxpayer is generally prohibited from making a new election for the subsequent 60 months.¹¹⁰

¹⁰⁴ Treas. Reg. § 1.987-3(b)(4)(i).

¹⁰⁵ Treas. Reg. § 1.987-3(b)(4)(ii).

¹⁰⁶ Treas. Reg. § 1.987-1(d)(1)(iii).

¹⁰⁷ Treas. Reg. § 1.987-2(b)(3)(iv).

¹⁰⁸ Treas. Reg. § 1.987-1(g)(2).

¹⁰⁹ Treas. Reg. § 1.987-1(g)(3)(ii)(A).

¹¹⁰ Treas. Reg. § 1.987-1(g)(3)(ii)(B).

- There are special rules for section 987 elections for the first taxable year in which the Final Regulations apply. A taxpayer may make any section 987 election for the first year to which the Final Regulations apply without the consent of the IRS. Moreover, such elections can be filed with the taxpayer's original, timely filed tax return (including with extensions) for the first taxable year to which the Final Regulations apply. As a result, a taxpayer generally can make *any* section 987 election for the first year without the IRS's consent and can include such election with the filing of its tax return, including any extensions.¹¹¹
- However, any elections made for taxable years after the first effective taxable year are subject to the general rules above. Unlike elections made for the first taxable year, taxpayers wishing to make or revoke CRE, ARE, and mark-to-market elections, or other section 987 elections for subsequent taxable years must file the elections *on or before* the first day of the taxable year to which the election applies.¹¹²

Observations:

Section 987 elections require that taxpayers make such elections consistently for all members of the controlled group. As a result, taxpayers should very carefully consider the impacts of the elections on all entities within the controlled group that hold section 987 QBUs. Moreover, taxpayers have significant advantages to making the CRE, ARE, mark-to-market, and other section 987 elections for the first taxable year (including additional timing to make the elections with the extended due date of their returns and hindsight to model the impacts of the elections on their return filing positions for the first taxable year) that are unavailable in future taxable years. As a result, taxpayers should consider using the flexibility provided for the first taxable year and model and make any relevant section 987 elections.

Recordkeeping and reporting requirements

- **Recordkeeping requirements:** The final section 987 regulations contain extensive recordkeeping requirements that are set forth in Treas. Reg. § 1.987-9(a) and (b). The Final Regulations also contain reporting requirements with respect to the determinations of section 987 gain or loss and section 987 taxable income or loss.¹¹³ Treas. Reg. § 1.987-9(a) and (d) indicate that the IRS may publish forms in the future in which elections can be made and amounts reported.
- The section 987 regulations are flexible and can be tailored to a particular taxpayer by making certain elections. Treas. Reg. § 1.987-9(a) requires that an owner (or authorized person on behalf of the owner) must keep a copy of each election made under Treas. Reg. § 1.987-1(g)(3)(i) by the owner with respect to a section 987 QBU. Treas. Reg. § 1.987-9(a) also requires that an owner (or authorized person) maintain "reasonable records" sufficient to establish section 987 taxable income or loss and section 987 gain or loss with respect to each QBU, successor deferral QBU, and suspended loss QBU.

¹¹¹ Treas. Reg. § 1.987-1(g)(3)(ii)(C).

¹¹² Treas. Reg. § 1.987-1(g)(3)(ii).

¹¹³ Treas. Reg. § 1.987-9(d).

- Treas. Reg. § 1.987-9(b) lists 14 items of information that must be maintained in the owner’s records (or in the records of an “authorized person” on behalf of the owner) to satisfy the recordkeeping requirements of section 6001 of the Internal Revenue Code. A complete list and full discussion of these items of information is beyond the scope of this alert. With that being said, the list includes:
 - The amounts of items of income, gain deduction or loss attributed to the section 987 QBU in the functional currency of the QBU and its owner
 - The adjusted balance sheet of the section 987 QBU in the functional currency of the QBU and its owner. If the QBU makes calculations under the quasi-1991 method approach set forth in Treas. Reg. § 1.987-4(e)(2)(iii) without preparing a tax balance sheet, then the information needed to comply with the quasi-1991 method approach must be maintained in lieu of an adjusted balance sheet.
 - The exchange rates used for tax purposes to translate the QBU income statement and balance sheet into the owner’s functional currency
- Other information on the list includes items relating to transfers to and from the QBU, the amount of unrecognized section 987 gain or loss for the taxable year and the amount of the accumulated unrecognized section 987 gain or loss for the taxable year, the amount of the remittance and the remittance proportion for the taxable year, information used to source and characterize section 987 gain or loss, the cumulative suspended loss in each recognition grouping, the outstanding deferred section 987 gain or loss in each recognition grouping, transition information required to be determined under Treas. Reg. § 1.987-10(k), and identifications required under Treas. Reg. § 1.987-14(c) relating to section 987 hedging transactions.
- **Reporting requirements:** Under Treas. Reg. § 1.987-9(d), 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 (which has not yet been published). Until that form is published, this information must be reported on Form 8858 or its successor. To the extent the taxpayer provides the specific information required by Treas. Reg. § 1.987-9(a) and (b) on the form, the taxpayer is considered to have met its requirements under Treas. Reg. § 1.987-9(a) and (b).
- **Retention of records:** Records required by Treas. Reg. § 1.987-9(a) and (b) and records that support the information reported on the form under Treas. Reg. § 1.987-9(d) must be maintained and kept available for inspection by the IRS for so long as the contents of such records may become relevant in the administration of the Internal Revenue Code.

Observations:

The recordkeeping and reporting requirements are extensive and require detailed maintenance of records. Companies subject to section 987 are advised to consider how such records will be maintained and who will maintain them.

Financial reporting

For financial reporting purposes, the Final Regulations represent new information that should be considered in reporting periods including the date in which the regulations were issued. The impact of the Final Regulations on financial statements will depend on the entity's facts and circumstances.

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