



United States Tax Alert

New Section 987 regulations: key considerations and observations

Overview

On December 7, 2016, the Internal Revenue Service (IRS) and Department of the Treasury (“Treasury”) issued a comprehensive package of regulations that provide long-awaited guidance under section 987 and amend related existing rules under sections 861, 985, 988, and 989. The package consists of final regulations,¹ which generally have a delayed effective date (the “Final Regulations”), and temporary regulations,² which in some instances have immediate application (the “Temporary Regulations”).

The Final Regulations provide rules for determining income or loss with respect to a qualified business unit (QBU) operating in a functional currency that is different from that of its owner (“Section 987 QBU”). The Final Regulations also provide rules for determining the timing, amount, character, and source of section 987 gain or loss realized by the taxpayer with respect to such QBUs. The Final Regulations are similar to the proposed regulations issued in 2006³ (the “2006 Proposed Regulations”), with several important distinctions, and generally apply to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. However, taxpayers may elect to apply the new regulations to the first taxable year beginning after December 7, 2016. The Final Regulations exclude certain taxpayers from the scope, but the preamble provides that such taxpayers must use a reasonable approach to comply with section 987.

The Temporary Regulations establish section 987 loss deferral rules for certain transactions entered into after January 6, 2017, with immediate application to tax avoidance transactions entered into after December 6, 2016. The Temporary Regulations also provide certain elections and other rules which, subject to exceptions, track the effective date of the Final Regulations as described above.

I. Key provisions with immediate impact on taxpayers

A. Deferral rules

The Temporary Regulations provide a set of complicated deferral rules intended to prevent taxpayers from triggering section 987 gains and losses in connection with certain prescribed categories of transactions entered into between related parties that result in QBU terminations (a “Deferral Event”). In addition, for QBU terminations constituting “Outbound Loss Events,” the rules apply to defer section 987 losses, but not gains. The rules addressing Deferral Events and Outbound Loss Events (together, the “Deferral Rules”) apply to prescribed transactions entered into on or after January 6, 2017, but apply as of December 7, 2016 to any such transactions undertaken with a principal purpose of recognizing a section 987 loss.⁴ The Deferral Rules apply to prescribed transactions entered into by taxpayers under their present method of accounting for section 987 as well as transactions undertaken after the taxpayer becomes subject to the final section 987 regulations. The rules also apply to taxpayers that are excluded from the application of the final regulations (e.g., banks, insurance companies, non-aggregate partnerships (defined in III.A. below), S corporations, trusts). Note that, under a de minimis rule, the Deferral Rules do not apply to a QBU for a taxable year if the net section 987 gain or loss of the QBU that hypothetically would be deferred for the taxable year is \$5 million or less. In general, the Deferral Rules defer section 987 gain or loss in the following situations.

Terminations of Section 987 QBUs

In general, any QBU termination is treated as a Deferral Event, resulting in deferral of both section 987 gain and loss, if immediately after the Deferral Event the assets of the transferred QBU are reflected on the books of a “Successor QBU,” which in essence is a QBU that continues to qualify as a Section 987 QBU in the hands of the transferee. A Successor QBU exists only if the transferor and the transferee are members of the same controlled group. A controlled group includes all persons with a relationship described in section 267(b) or 707(b). In addition, in the case of a US person transferor, the owner of the Successor QBU must be a US person.

The following three categories of termination events are not treated as Deferral Events: (i) the owner of a QBU ceases to be a controlled foreign corporation (CFC); (ii) a QBU is transferred in certain asset reorganizations or liquidations subject to section 381; and (iii) terminations resulting solely from the cessation of the trade or business of the Section 987 QBU.

Thus, a termination of a Section 987 QBU resulting from a *domestic-to-domestic* transfer between members of the controlled group, whether the transfer is taxable or non-taxable, is treated as a Deferral Event resulting in the deferral of section 987 gain or loss.

Similarly, a termination of a Section 987 QBU resulting from a *foreign-to-foreign* transfer between members of the controlled group, whether the transfer is taxable or non-taxable, is treated as a Deferral Event resulting in the deferral of section 987 gain or loss, unless the functional currency of the transferee and the transferred QBU is the same or there is otherwise no Successor QBU.

A termination resulting from a related party *inbound* section 381 transfer is not subject to the general deferral rule. Other inbound transfers require additional analysis depending on the facts.

For related party *outbound* transfers of QBUs (i.e., taxable or nontaxable transfers by a US person to a foreign person, if both are members of the same controlled group), section 987 gain is generally recognized (because the Deferral Rule does not apply), while section 987 *loss* is generally deferred under the Outbound Loss rule.

Certain remittances from partnership and disregarded entities

The regulations also defer section 987 gains and losses that arise in connection with certain transactions involving partnerships and disregarded entities (DE) which result in deemed remittances under the taxpayer's present method of accounting for section 987, or under the final regulations when they become effective. Such transactions include (i) a disposition of part of an interest in a DE or section 987 Aggregate Partnership (defined in III.A. below) through which a Section 987 QBU is held that results in a remittance and (ii) a contribution of assets by a related person to the partnership or DE described above, provided that (i) the contribution causes a net transfer from a Section 987 QBU and (ii) the contributed assets are not included on the books and records of an eligible QBU.⁵

In addition, under the rules applicable to Outbound Loss Events, section 987 losses are deferred but gains may be recognized in connection with deemed remittances under the taxpayer's present method of accounting for section 987 or under the final regulations when they become effective, resulting from (i) a transfer by a US person of part of an interest in a Section 987 Aggregate Partnership or DE through which the US person owns the Section 987 QBU to a related foreign person that has the same functional currency as the Section 987 QBU; and (ii) a contribution of assets by a related foreign person to the partnership or DE described above that results in a deemed remittance (provided that the assets contributed are not considered to be included on the books and records of an eligible QBU).⁶

Recognition of deferred losses

Taxpayers have a limited ability to recognize deferred section 987 gains and losses. If applicable, deferred section 987 gain or loss is recognized by the original tax owner/transferor ("Deferral QBU Owner") as the Successor QBU makes remittances to the new tax owner (the "Successor QBU Owner") or when the Successor QBU ceases to be owned by a member of the Successor QBU Owner's controlled group.⁷

Special rules apply to section 987 losses deferred upon an Outbound Loss Event. If an Outbound Loss Event results from a section 351 or section 361 transaction, the deferred section 987 loss is used to increase the basis of the stock received by the QBU owner.⁸ In any other Outbound Loss Events, the deferred section 987 loss is only recognized if the QBU owner (or any qualified successor of the QBU owner) ceases to be a member of a controlled group that includes the related foreign person.⁹

Observations

- The Deferral Rules do not apply to section 987 gain or loss from change of functional currency.
- Subject to the special rules related to partnerships discussed above, the Deferral Rules generally do not apply to remittances of property.
- Deferred section 987 gain or loss not triggered prior to the adoption of the final regulations is restated to equal the section 987 gain or loss that would have been recognized had the new

rules applied on the date of the termination. Therefore, all or a portion of a deferred section 987 loss under the taxpayer's old method that is not recognized prior to the effective date of the Final Regulations would be permanently disallowed upon transition to the Fresh Start transition method.

The Temporary Regulations provide a broad anti-abuse rule that may result in deferral of losses in transactions undertaken with a principal purpose of avoiding the purpose of the Deferral Rules.

B. Fresh Start transition

Taxpayers are required to use the "Fresh Start" method to transition to the new regulations. Under the Fresh Start method, solely for section 987 purposes, all Section 987 QBUs of an owner are deemed terminated on the last day of the taxable year preceding the "transition date," and the owner is treated as transferring the assets and liabilities attributable to such QBU to a new Section 987 QBU on the transition date. No section 987 gain or loss is recognized on the deemed termination. All assets and liabilities deemed transferred to the new Section 987 QBU are translated using historic exchange rates. According to the preamble to the Final Regulations, except for previously recognized section 987 gain or loss, "the effect of the fresh start method is as if the assets and liabilities on the books and records of a Section 987 QBU on the transition date had been the only assets and liabilities held by the QBU from its inception."

Observations

- The Fresh Start method effectively preserves section 987 gain or loss on certain assets and liabilities on the books of the QBU at the time of the transition, but eliminates (or, in part, recharacterizes) all other unrecognized section 987 gain or loss determined under the owner's prior method.
- Exceptions and special rules are provided for taxpayers who have already adopted the 2006 Proposed Regulations, because the Final Regulations do not contain "fundamental" differences from such rules.

C. ASC 740 implications

The Final and Temporary Regulations represent a change in law. Due to the Fresh Start transition method provided by the Final Regulations taxpayers may need to adjust deferred taxes previously recorded with respect to unrealized foreign currency exchange gains and losses. Although the Final Regulations have a prospective effective date, entities will need to assess and record, through income tax expense attributable to continuing operations, the impact on their deferred taxes discretely in the period of enactment (i.e., the reporting period that includes December 2016).

D. Annual deemed termination election

The Temporary Regulations provide an election for taxpayers to deem their Section 987 QBUs to terminate on the last day of each taxable year. Calendar-year taxpayers subject to the Final Regulations can make this election as early as January 1, 2017 if such taxpayers early-adopt the Final Regulations.¹⁰ Calendar-year taxpayers subject to the Final Regulations who do not early-adopt the Final Regulations may make this election as of January 1, 2018 or later. On the other hand, taxpayers who are not subject to the Final Regulations but are required to comply with section 987 using a reasonable method may make this election as of January 1, 2017.¹¹ Finally, calendar-year taxpayers who have already adopted the 2006 Proposed Regulations can also make this election as of January 1, 2017.

Taxpayers who make this election will recognize section 987 gain or loss on an annual mark-to-market basis.¹² The benefit of making this election is that the Deferral Rules described above do not apply.¹³ Furthermore, a taxpayer that has made this election may also elect to translate all items of income, gain, deduction and loss of a Section 987 QBU into the owner's functional currency at the yearly average rate.¹⁴ This yearly average rate election simplifies the computation of the owner's income or loss with respect to historic items.

Note that the annual deemed termination election, once made, applies to all Section 987 QBUs owned by the electing taxpayer and Section 987 QBUs owned by persons related (generally as defined in section 267(b) or 707(b)) to the electing taxpayer.¹⁵

Observation

A taxpayer that is not subject to the Final Regulations, but has adopted a reasonable method to account for its section 987 gain or loss, may find it beneficial to make this election as of January 1, 2017 if it has built-in section 987 losses – because neither the Fresh Start transition nor the Deferral Rules apply. Note that because this election applies to all QBUs and may not be revoked without IRS consent, the taxpayer should weigh its current tax benefit against potential future mark-to-market currency gains if this and other QBUs' functional currency appreciates against the owner's functional currency.

II. Key takeaways from the Final Regulations

A. Taxpayers within scope

The Final Regulations apply only to individuals and corporations that own Section 987 QBUs directly (including through DEs) or indirectly through section 987 Aggregate Partnerships. A Section 987 Aggregate Partnership is a partnership entirely owned by persons related under section 267(b) or 707(b), if the partnership owns one or more eligible QBUs that would be a Section 987 QBU to the partner. A Section 987 QBU is defined to mean an "eligible QBU" that has a functional currency that is different from its owner. An "eligible QBU" means a QBU as defined in the section 989(a) regulations, subject to specific exclusions. While the section 989 regulations continue to treat corporations, trusts, estates, and non-aggregate partnerships as per se QBUs,¹⁶ the Final Regulations exclude all such per se QBUs from the definition of "eligible QBUs."¹⁷ In other words, only *activities* of a corporation, partnership, trust, estate, or individual that amount to a separate QBU under section 989(a) regulations¹⁸ can be eligible QBUs. The Final Regulations retain the "flat approach" with respect to tiered eligible QBUs and treat each relevant QBU as held directly by the individual or corporate owner.

The Final Regulations do not apply to trusts, estates, S corporations, or partnerships other than Section 987 Aggregate Partnerships ("non-aggregate partnerships"). Also, the Final Regulations do not apply to certain "specified entities," such as banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, or real estate investment trusts, other than specified entities that engage in transactions primarily with related parties that are not themselves specified entities. The preamble states that all such excluded entities must comply with section 987 using a reasonable method (which does not include the Final Regulations themselves).

Observations

- Eligible QBUs under non-aggregate partnerships appear to be outside of the scope of the Final Regulations because they are not "directly" or "indirectly" owned by individuals or

corporations.

- As mentioned above, the scope of the Deferral Rules in the Temporary Regulations is broader than the scope of the Final Regulations; such rules apply to persons otherwise excluded from the Final Regulations.

B. Foreign exchange exposure pool method

The Temporary and Final regulations generally retain the balance sheet approach from the 2006 Proposed Regulations, referred to as the “foreign exchange exposure pool” (“FEEP”) method, in determining taxable income or loss and section 987 gain or loss of a Section 987 QBU. Under the FEEP method, section 987 gain or loss is computed only with respect to specific categories of a QBU’s assets and liabilities, which generally correspond to financial assets and liabilities denominated in the QBU’s functional currency that would give rise to exchange gain or loss under section 988 if held directly by the regarded tax owner of the QBU.

In summary, under the FEEP calculation, the profit and loss statement and balance sheet of the QBU, measured in the QBU’s functional currency, are translated into the owner’s functional currency. The owner’s functional currency change in net worth during a tax year is then adjusted under a multi-step process to eliminate the impact of changes in net worth during the tax year that are unrelated to movements in exchange rates on marked assets and liabilities.¹⁹ After all adjustments are made and translation gain or loss on marked assets and liabilities is isolated, the amount of such gain or loss is added to a cumulative pool from prior years of “net unrecognized section 987 gain or loss.” Such gain or loss is recognized as the QBU makes “remittances” or is terminated.

The Final Regulations make several significant changes to the 2006 Proposed Regulations. First, the regulations add a new step to the FEEP calculation to address the treatment of tax-exempt income and non-deductible expenses of a QBU. Second, the Final Regulations also provide greater flexibility with regard to the exchange rates to be used in translating the taxable income or loss and the balance sheet of the QBU. Specifically, the Final Regulations no longer require historic items to be translated using the spot rate on the date each of the QBU’s assets and liabilities were acquired or incurred, but rather allow the use of average exchange rates for the year in which historic assets or liabilities were acquired or incurred. Third, the Final Regulations provide a simplified approach involving the use of average rates for translating costs of goods sold and inventory, which was a major complication under the 2006 Proposed Regulations. For marked assets, the Final Regulations replace the complicated rules of the 2006 Proposed Regulations dealing with sales of marked assets by providing that such gain or loss is determined in the QBU’s functional currency and translated into the owner’s functional currency at the average rate for the year of sale. The Final Regulations also change the approach of the 2006 Proposed Regulations to treat prepaid expenses and liabilities for advance payments of unearned income as marked assets and liabilities, respectively, which simplifies the translation of such items relative to their treatment as historic items under the 2006 Proposed Regulations.

C. Attribution of items to a Section 987 QBU

The Final Regulations largely retain the rules from the 2006 Proposed Regulations addressing the attribution of “items” (i.e., assets, liabilities, income, gain, losses, and deductions) to a Section 987 QBU. The Final Regulations change the definition of “portfolio stock” in the 2006 Proposed Regulations to provide that the determination is now made solely with regard to the value of the stock held by a QBU. Thus,

stock held by a QBU is not attributed to the QBU for purposes of section 987 if the QBU holds directly, indirectly, or constructively at least 10 percent of the value of the stock.

D. Section 987 QBU terminations

The Final Regulations largely retain the termination rules provided by the 2006 Proposed Regulations, with certain modifications. Under the Final Regulations, the termination of a Section 987 QBU is treated as a remittance of all of the QBU's gross assets to its owner,²⁰ and any unrecognized section 987 gain or loss with respect to the QBU is recognized (subject to the Deferral Rules discussed above).²¹

E. Source and character of section 987 gain or loss

The Final Regulations retain the rule under the 2006 Proposed Regulations that an owner of a Section 987 QBU must determine the source and character of section 987 gain or loss for all purposes of the Code, including sections 904(d), 907, and 954, using the asset method provided in Treas. Reg. §1.861-9T(g). As a result, under the Final Regulations, section 987 gain or loss recognized by a CFC is generally treated as subpart F income in the same proportion that the assets of the QBU giving rise to subpart F income bear to the total assets held by the QBU.

In addition, the Final Regulations provide that section 987 gain or loss attributed to subpart F under the asset method is treated as an adjustment to foreign personal holding company income (FPHCI) under the rules of section 954(c)(1)(D) applicable to section 988 transactions. In essence, such gains and losses are treated as attributable to section 988 transactions that fail the "business needs" exception to FPHCI provided by section 954(c)(1)(D) and Treas. Reg. §1.954-2(g).

F. Treatment of partnerships

The Final Regulations (like the 2006 Proposed Regulations and unlike the existing section 989 regulations) apply an aggregate approach to "Section 987 Aggregate Partnerships," which as described above are partnerships entirely owned by persons related under sections 267(b) or 707(b), if the partnership owns one or more eligible QBUs that would be a Section 987 QBU to the partner. Such a partnership is no longer treated as a per se QBU (and therefore cannot itself adopt a functional currency). The activities of such a partnership (conducted directly, or through DEs or branches) can be an eligible QBU and in turn a Section 987 QBU with respect to each partner that has a different functional currency than the QBU. The partners account for their shares of the Section 987 QBUs owned indirectly through section 987 aggregate partnerships.

The Temporary Regulations provide specific rules for determining a partner's share of the assets and liabilities of QBUs that are attributed to each partner through section 987 aggregate partnerships. Specifically, each partner's share of any Section 987 QBU it owns indirectly through the Section 987 Aggregate Partnership is determined based upon the partner's "liquidation value percentage." A partner's "liquidation value percentage" expresses the relative liquidation value of the partner's interest in the partnership on prescribed determination dates.

On the other hand, non-aggregate partnerships continue to be treated as per se QBUs under the revised section 989 regulations. Therefore, such partnerships can themselves have a different functional currency than their partners, in addition to having activities that amount to

QBUs with different functional currencies. Neither such partnerships (nor their QBUs) are currently subject to the Final Regulations. The preamble does state that partnerships must comply with section 987 using a reasonable method (which excludes the Final Regulations). Further, the preamble indicates that it anticipates developing regulations for applying section 987 to non-aggregate partnerships, potentially using an approach that differs from the aggregate approach adopted in these new rules, and requests comments on a number of related issues, including the application of an entity approach to non-aggregate partnerships.

Observations

- It is not clear how to address pre-existing aggregate partnerships (previously per se QBUs) that have adopted a functional currency but no longer qualify as QBUs.
- Partnerships that still appear to qualify as per se QBUs include: certain partnerships with unrelated partners and certain partnerships with no eligible QBUs.
- Unless items on the books of a section 987 Aggregate Partnership are attributable to an eligible QBU, each partner must account for the items on the books of such partnership in the partner's respective functional currency.
- Accounting for an aggregate partnership's earnings when it legally owns multiple QBUs with different functional currencies and is owned by partners with different functional currencies will be extremely complex.

The general determination of income or loss of the section 987 Aggregate Partnership is done in accordance with the regular rules in subchapter K. The Final Regulations reserve, however, on certain consequences of the disposition of the Section 987 Aggregate Partnership and other coordination with subchapter K rules.

G. Section 988 rules

Consistent with the 2006 Proposed Regulations, the Temporary Regulations provide that transactions denominated in the owner's functional currency ("specified Owner Functional Currency Transactions") are not subject to section 988. The Final Regulations simplify the translational computation by providing that the basis and amount realized with respect to a historic asset that gives rise to a Specified Owner Functional Currency Transaction are not translated if denominated in the owner's functional currency.²²

Whether a transaction is a section 988 transaction is determined by reference to the Section 987 QBU's functional currency. However, the amount of section 988 gain or loss is generally determined by the functional currency of the owner of the Section 987 QBU. With respect to a "qualified short-term section 988 transaction" (including hedges related to such transactions),²³ the amount of section 988 gain or loss is determined in the Section 987 QBU's functional currency if the section 988 gain or loss is accounted for under a mark-to-market method of accounting for US federal income tax purposes (including an elective method described immediately below).

Annual mark-to-market election for Section 988 transactions

Temporary and Final Regulations allow taxpayers to mark to market certain qualified short-term section 988 transactions entered into in the ordinary course of the QBU's trade or business, including cash, receivables, payables, and related hedges not otherwise marked under section 475 or 1256.²⁴ This election can be made on a QBU-by-QBU basis. Essentially, section 988 transactions that are subject to the mark-to-market accounting are treated as marked items under Temp.

Treas. Reg. §1.987-1T(d)(3), with the result that gain or loss attributable to such items is translated at the yearly average rate and would give rise to unrecognized section 987 gain or loss. The intent behind this treatment is to more closely match the financial accounting treatment for certain section 988 transactions of section 98 QBUs.

Observation

This election may be beneficial to taxpayers with 987 QBUs that conduct foreign treasury operations using short-term cash pooling and other similar arrangements.

Dollar QBUs

The Temporary Regulations provide that section 987 does not apply to an eligible QBU that has the US dollar as its functional currency. A CFC that has a US dollar QBU is required to account for section 988 gain or loss with respect to transactions of the US dollar QBU that would be section 988 transactions if entered into by the CFC. The amount of section 988 gain or loss is determined by reference to the CFC's functional currency. A CFC may elect to apply section 987 to its US dollar QBU in lieu of section 988. With respect to CFCs that are outside the scope of the Final Regulations, such CFCs must apply section 987 to the US dollar QBU using a method they applied immediately prior to the effective date of the Temporary Regulations, and such method must be a reasonable method.

Deferral of section 988 loss by the issuer with respect to a related party loan

Treas. Reg. §1.988-2T(b)(16) adopts an anti-abuse rule similar to that of Treas. Reg. §1.267(f)-1(e) with respect to issuers of section 988 denominated debt instruments. In essence, an issuer's section 988 loss is deferred if the debt is issued to a related person (as defined under section 267(b) or section 707(b)) and the transaction resulting in the realization of exchange loss has as a principal purpose the avoidance of federal income tax. Any deferred section 988 loss under this section is deferred until the end of the original term of the loan.

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¹ TD 9794 (Dec. 8, 2016).

² TD 9795 (Dec. 8, 2016). *The Temporary Regulations are accompanied by final regulations (cross referencing the Temporary Regulations) and proposed regulations (REG-128276-12, repeating the Temporary Regulations).*

³ 71 Fed. Reg. 52876 (Sept. 6, 2006).

⁴ Temp. Treas. Reg. §1.987-12T(j).

⁵ Temp. Treas. Reg. §1.987-12T(b)(2)(ii)(B).

⁶ Temp. Treas. Reg. §1.987-12T(d)(2)(ii).

⁷ Temp. Treas. Reg. §1.987-12T(c)(2).

⁸ Temp. Treas. Reg. §1.987-12T(d)(4).

⁹ Temp. Treas. Reg. §1.987-12T(d)(5).

¹⁰ Temp. Treas. Reg. §§1.987-8T(d) and (g).

¹¹ Temp. Treas. Reg. §1.987-1T(g)(2)(i)(B).

¹² Temp. Treas. Reg. §1.987-8T(d).

¹³ Temp. Treas. Reg. §1.987-12T(a)(3)(i).

¹⁴ Temp. Treas. Reg. §1.987-3T(d).

¹⁵ Temp. Treas. Reg. §1.987-1T(g)(2)(i)(B)(1).

¹⁶ Treas. Reg. §1.989(a)-1(b)(2)(i).

¹⁷ Treas. Reg. §1.987-1(b)(3)(ii).

¹⁸ Treas. Reg. §1.989(a)-1(b)(2)(ii).

¹⁹ Prop. Treas. Reg. §1.987-4(d), 71 Fed. Reg. 52876, 52904 (Sept. 6, 2006).

²⁰ Treas. Reg. §1.987-8(e).

²¹ Treas. Reg. §1.987-5(c)(3).

²² Temp. Treas. Reg. §1.987-3T(b)(2)(ii).

²³ Defined as a section 988 transaction that occurs in the ordinary course of a Section 987 QBU's business and has an original term of one year or less on the date the

transaction is entered into by the Section 987 QBU. Nonfunctional currency cash that constitutes working capital is also included in this definition. Temp. Treas. Reg. §1.987-3T(b)(4)(iii)(B).

²⁴ Temp. Treas. Reg. §1.987-3T(b)(4)(iii)(C).

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