



The New Proposed 987 Regulation: Pitfalls and Opportunities

June 11, 2024

Ahead
of the **wave**

2024 U.S. Cross-Border Tax Conference



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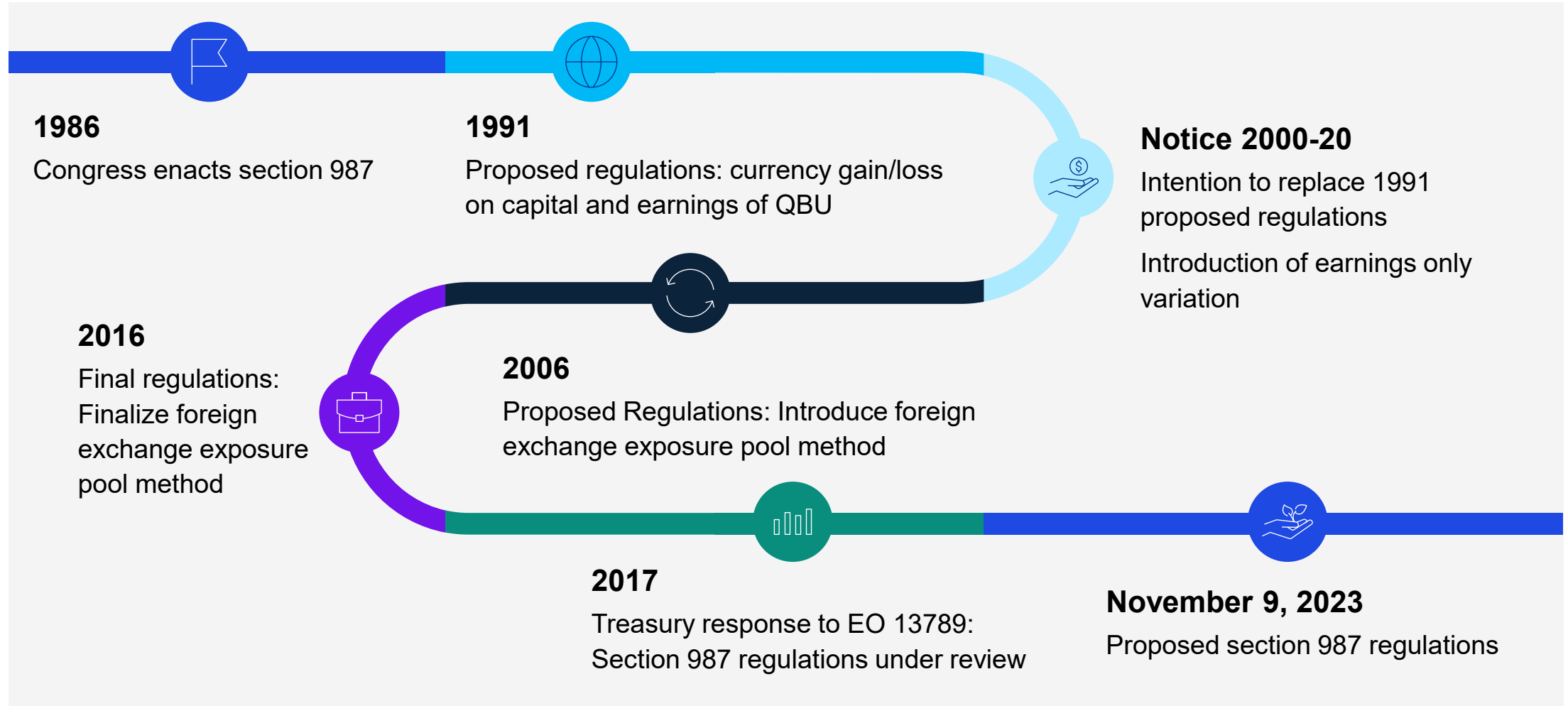
Selected issues: sourcing character

Section 987-1986 Tax reform act

A taxpayer having one or more QBUs with a functional currency other than the US dollar shall determine its taxable income by:

- Computing taxable income for each QBU in its functional currency,
- Translating the income or loss of the QBU into the taxpayer's functional currency at the appropriate exchange rate, and
- Making "proper adjustments" as set forth in regulations to account for transfers of property between QBUs of the taxpayer

Journey map



2023 Proposed regulations highlights

Expanded scope	FEEP	Transition	Simplifying elections
<ul style="list-style-type: none"> Previously excluded entities are brought within scope Banks, insurance companies, leasing companies, finance coordination centers, RICs, and REITs. 	<ul style="list-style-type: none"> Retains method proposed in 2006 and finalized in 2016 as a general rule. Requires tracking of historical exchange rates of non-financial assets 	<ul style="list-style-type: none"> May suspend 987 loss recognition until the owner recognizes a section 987 gain of the same source and character Looks forward and not back 	<ul style="list-style-type: none"> Current Rate Election: Simple but subject to loss suspension rules Annual Recognition Election: Recognize section 987 gain/loss without regard to remittances
Loss suspension	Partnerships	Consolidated regulation coordination	Section 988
<ul style="list-style-type: none"> Generally applies to losses from pretransition period, when current rate election in effect, and on certain terminations Outbound section 987 loss becomes suspended loss and not adjustment to stock basis Loss recognition to the extent of future gain 	<ul style="list-style-type: none"> Retains aggregate approach for partnerships wholly owned related persons Hybrid approach for other partnerships 	<ul style="list-style-type: none"> Clarification on result of transactions between one member with QBU of another member Treated as a transaction between members AND transfer between member owner and QBU 	<ul style="list-style-type: none"> Transactions denominated in owner currency are not 988 Identify 988 transactions by reference to QBU currency but determine 988 gain/loss by reference to owner currency Exception for short-term section 988 transactions if elect mark-to-market

1991 Proposed vs. FEED

1991 proposed method

P&L Statement

- Taxable income/loss computed in QBU functional currency
- Generally translated at average exchange rate for the year
- Other changes to balance sheet translated at spot rate

987 gain/loss

- Proportionate share of basis pool vs. spot rate on remittance
- Earnings: Annual average when earned vs. spot rate
- Capital: Spot contributed vs. spot rate

Method generally results in greater section 987 gain/loss

Foreign exchange exposure pool

P&L Statement

- Items of income/deductions generally translated at average exchange rate
- Expenses with respect to historic assets translated at historic rates (e.g., depreciation, amortization, COGS, basis in property)

987 gain/loss

- Designed to capture FX movements related solely to financial assets and liabilities

Method excludes non-financial items resulting in smaller section 987 gain/loss

01

Transition Rules and Effective Dates



Transition rules

Eliminates “fresh start” transition and requires computation of pretransition gain or loss based on pretransition method

Eligible method

- Capital and earnings method (e.g., 1991 proposed method)
- Earnings only (with conditions)
- Compute pretransition gain/loss on existing method

Pretransition gain/loss

- Gain becomes unrecognized section 987 gain of QBU
- Loss is suspended section 987 loss
- Election to amortize over 10 years

Ineligible method

- No currency gain/loss recognized on prior remittances
- Compute pretransition gain/loss on simplified FEEP method

Reporting

- Robust information reporting requirements including amount of pretransition gain/loss and method of computation

987 proposed regulations – Effective dates

Applicable to tax years beginning after December 31, 2024

- Early application on a terminating QBU.

Options for tax years ending after November 9, 2023 and beginning before December 31, 2025

- Continue current method including 1991 proposed method and earnings only (with conditions)
- Adopt 2016 final regulations using the 2023 transition rules
- Adopt 2023 proposed regulations

Termination triggers early application!

Watch OUT! Terminations

- **QBU terminations may result in early applicability**
 - Terminating QBU is defined as a QBU that terminates on or after November 9, 2023, or before that date due to a CTB election filed on or after November 9, 2023, AND the 2016 / 2019 / 2023 regs would not otherwise apply to the QBU on the termination
- **Terminations**
 - Cease trade or business
 - Substantially all assets are transferred
 - Owner is no longer a CFC
 - Owner ceases to exist
 - QBU no longer a section 987 QBU (NEW)
 - The owner of the QBU changes its form of owner (NEW)
- **Reorganizations are generally not terminations unless**
 - Inbound or outbound
 - QBU ceases to be a section 987 QBU (distribute or transferee has the same currency as the QBU)
 - Results in a change in CFC status

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FEEP method



Calculating net income: General rule

Income statement

- Sales
- Cost of Goods Sold
- Depreciation
- SG&A
- Net Income/Loss



Translation

Sales

Yearly Average Exchange Rate

Cost of Goods Sold

“Simplified Method”

- Yearly Average Exchange Rate adjusted for “cost recovery deductions” (e.g., Depreciation) (see Appendix)

Historic Inventory Method

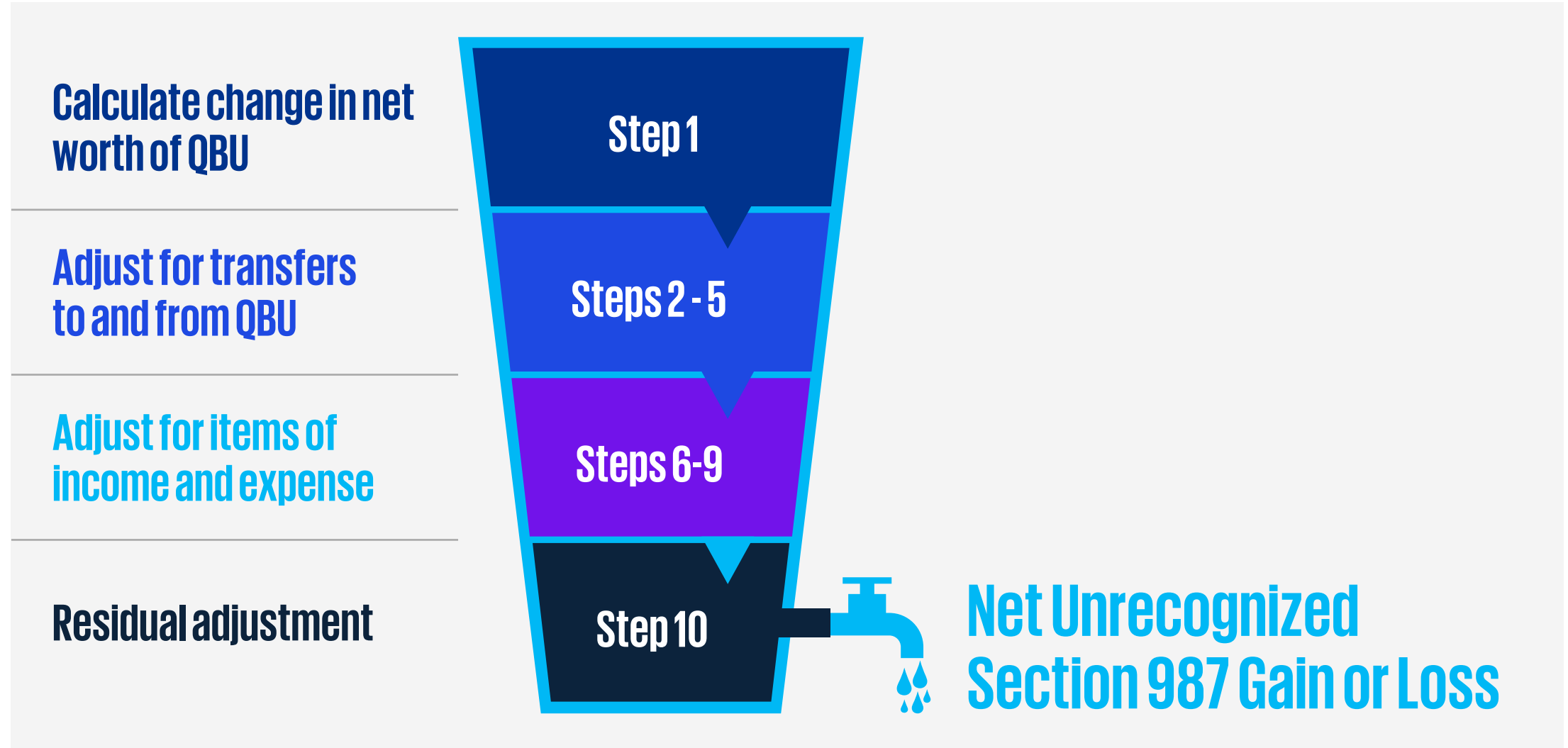
Depreciation

Historic Exchange Rate

SGA

Yearly Average Exchange Rate

Section 987 gain or loss



Recognition of 987 gain/loss

When there is a remittance, the owner recognizes a pro-rata share of its accumulated unrecognized section 987 gain

$$\begin{array}{|c|} \hline \text{Accumulated} \\ \text{Unrecognized 987 Gain} \\ \text{or Loss} \\ \hline \end{array} \quad \times \quad \begin{array}{|c|} \hline \text{Remittance Proportion} \\ \text{Remittance} \div \\ \text{(Remittance + Gross Assets)} \\ \hline \end{array} \quad = \quad \begin{array}{|c|} \hline \text{Recognized 987} \\ \text{Gain/Loss} \\ \hline \end{array}$$

Termination may result in suspended loss rules

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Elections



Comparison of elections

FEEP

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- Smaller base of section 987 gain/loss
- Control recognition of gain / loss through remittances

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- Complex translation of income statement
- Requires tracking of historic exchange rates

Current Rate Election

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- Less complex
- P&L computed at average rates

-

- Loss suspension applies
- Larger base of section 987 gain/loss

Annual Recognition Election

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- P&L computed at average rates
- Smaller base of section 987 gain/loss
- No loss suspension on terminations

-

- No control over timing of gain/loss recognition
- Requires tracking of historic exchange rates

Current Rate Election and Annual Recognition Election

+

- Less complex
- Generally, loss suspension does not apply

-

- No control over timing of gain/loss recognition
- Larger base of section 987 gain/loss

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Selected Issues



Sourcing and character

01

Asset Method Apportionment

- Ordinary income or loss
- Allocate to statutory and residual grouping based on assets of QBU under Treas. Regs. 1.861-9 and 9T

02

Allocation Unrelated to Underlying Earnings

- Allocation is tied to balance sheet in year of remittance
- Disconnected from character and source of historic income

03

GILTE High Tax Exception

- Treated as separate item for GILTI HTE
- Does not distort application of HTE to operating income of any tested unit
- HTE will generally not apply to 987 gain/loss because ETR will generally be expected to be zero

04

Business Needs

- If allocated to subpart F, then treated as section 988 gain/loss that does not meet business needs

02

Transition Under Ineligible Method



Example of ineligible calculation

	12/31/2021			12/31/2022			12/31/2023			12/31/2024		
	Book Basis	Book-to-Tax	Tax Basis	Book Basis	Book-to-Tax	Tax Basis	Book Basis	Book-to-Tax	Tax Basis	Book Basis	Book-to-Tax	Tax Basis
Assets												
Cash	10,000		10,000	50,000		50,000	30,000		30,000	25,000		25,000
Net Fixed Assets	200,000		200,000	100,000		100,000	150,000		150,000	135,000		135,000
Total Assets	210,000		210,000	150,000		150,000	180,000		180,000	160,000		160,000
Liabilities												
Accounts Payable - 3rd party	(50,000)		(50,000)	(25,000)		(25,000)	(30,000)		(30,000)	(20,000)		(20,000)
Loan from shareholder	(100,000)	100,000	-	100,000	(100,000)	-	100,000	(100,000)	-	100,000	(100,000)	-
Total Liabilities	(150,000)		(50,000)	75,000		(25,000)	70,000		(30,000)	80,000		(20,000)
Net Assets	60,000		160,000	225,000		125,000	250,000		150,000	240,000		140,000
YE spot (FC to USD)			1.0			1.1			1.2			1.3
Net assets - tax (USD)			160,000			137,500			180,000			182,000
change in OFCNV			160,000			(22,500)			42,500			2,000
change in QBU functional currency			160,000			(35,000)			25,000			(10,000)
average rate			0.95			1.05			1.15			1.25
change in QBUNV at average			152,000			(36,750)			28,750			(12,500)
unrealized 987 gain / (loss)			8,000			14,250			13,750			14,500
										accumulated 987 gain / (loss)		36,000
										987 gain / loss previously recognized		
										pretransition at [date]		36,000

Next steps

Prepare to comply with new regulations

Identify QBUs and Existing Methods

- Where are my QBUs?
- Are they on eligible methods?

Compute pretransition gain/loss

Under current method OR simplified FEEP method

Evaluate elections

- Amortization of pretransition gain/loss
- Current rate
- Annual recognition
- QBU grouping

Watch OUT!

Terminations could mean early application!

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Q&A



Q&A

If you submitted a question, someone from KPMG may contact you via phone or email. Or you may contact one of today's presenters directly:

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