Final Section 987 Regulations

Transforming tax.
Redefining connections.

2025 US Cross-Border Tax Summit

Notices

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IDEXX

Agenda

01	Overview
02	Transition examples
03	FEEP method
04	Elections
05	Examples

Overview

2024 final regulations highlights

Applicability date

- Tax years beginning after December 31, 2024
- Retroactive application to terminating QBUs

Taxpayers within scope

- Individuals and corporations
- Does not apply to trusts, estates, non-US individuals, and foreign corporations that are not CFCs
- Does not apply to partnerships in their entirety

Eligible pretransition method

- Expanded to generally include any method that reasonably complies with the statute
- Must have been applied consistently on a return filed before November 9, 2023
- Errors are not disqualifying but must be corrected in pretransition calculation

Additional simplifications for the Current Rate Election

- Alternative calculation of QBU net value that doesn't require tax basis balance sheet (still requires gross asset data)
- Hedging rules align g/l of a hedge with section 987 g/l of the hedged QBU
- Proposed recurring transaction election

Loss suspension

- New de minimis exception – lesser of $3 million or 2% of gross income (controlled group basis)
- 3-year look-back for purposes of applying loss-to-extent-of-gain rule (does not apply to pre-transition years)

Section 988 transactions

- All transactions that are or could be section 988 transactions in the hands of the owner or QBU are marked items
- Mark-to-market election available
- Identify and compute section 988 transactions by reference to QBU currency

Provisions that apply to partnerships

- Loss suspension and deferral rules
- Source and character rules
- Annual recognition election and 988 MTM election available

Remittance

- Remittance proportion calculated in QBU functional currency
- Alternative remittance calculation doesn't require tracking of individual transfers

02

Transition examples

Effective dates

Applicable to tax years beginning after December 31, 2024

> • If a QBU terminates on of after November 9, 2023 (or before due to CTB election filed on or after such date), regulations apply immediately before termination.

Options for tax years ending after November 9, 2023 and beginning before December 31, 2024

> • Continue current method including 1991 proposed method and earnings only (with conditions)
> • Adopt 2016 final regulations using the 2024 transition rules
> • Adopt 2024 final regulations

Termination triggers early application!

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)	(125,000)		(25,000)	(130,000)		(30,000)	(120,000)		(20,000)
Net Assets	60,000		160,000	25,000		125,000	50,000		150,000	40,000		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 (A)			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 (B)			152,000			(36,750)			28,750			(12,500)
Unrealized 987 gain/(loss) = (A) – (B)			8,000			14,250			13,750			14,500
Accumulated 987 gain/(loss) 987 gain/loss previously recognized												50,500
Pretransition at 12/31/2024												**50,500**

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Treatment of pretransition gain or loss

	Assuming Amortization Election is NOT made	
Method	**Pretransition loss**	**Pretransition gain**
Default FEEP	• Suspended loss of owner • Recognized to the extent of 987 gain	• Accumulated in QBU's unrecognized section 987 gain/loss amount • Recognized based on remittance proportion
CRE only in first year	• Accumulated in QBU's unrecognized section 987 gain/loss amount • If accumulated amount is negative, suspended based on remittance proportion	• Accumulated in QBU's unrecognized section 987 gain/loss amount • Recognized based on remittance proportion
ARE only in first year	• Suspended loss of owner • Recognized to the extent of 987 gain	• Accumulated in QBU's unrecognized section 987 gain/loss amount • Recognized in the first year election is effective
CRE and ARE at the same time	• Suspended loss of owner • Recognized to the extent of 987 gain	• Accumulated in QBU's unrecognized section 987 gain/loss amount • Recognized in the first year election is effective
CRE made in first year but ARE made in a later year	• Accumulated in QBU's unrecognized section 987 gain/loss amount • If accumulated amount is negative, suspended based on remittance proportion • Suspended in first year of ARE if owner's net loss exceeds $5M	• Accumulated in QBU's unrecognized section 987 gain/loss amount • Recognized in the first year election is effective
ARE only in later year	• Suspended loss of owner • Recognized to the extent of 987 gain	• Accumulated in QBU's unrecognized section 987 gain/loss amount • Recognized in the first year election is effective

03

FEEP method

Translating QBU income

Income Statement

- Sales
- COGS
- Depreciation
- SG&A

Default

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

CRE or ARE

Sales

Yearly Average Exchange Rate

Cost of Goods Sold

Yearly Average Exchange Rate

Depreciation

Yearly Average Exchange Rate

SGA

Yearly Average Exchange Rate

Owner functional currency net value

Marked Items

- **Cash**
- **AR/AP**
- **Debt instruments**
- **Short-term (one year or less) prepaids**
- **Derivatives**
- **Insurance reserves**
- **Separate account asset**

Year end spot rate

Historic Items

Everything that is not marked

Default or ARE

- **Average rate for year of acquisition**
- **Special rule for inventory**

CRE

Year end spot rate

Section 987 gain or loss
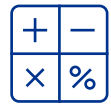
Calculate change in net worth of QBU

Adjust for transfers to and from QBU

Adjust for items of income and expense

Residual adjustment

Step 1

Steps 2 – 5

Steps 6-9

Step 10

Net Unrecognized Section 987 Gain or Loss
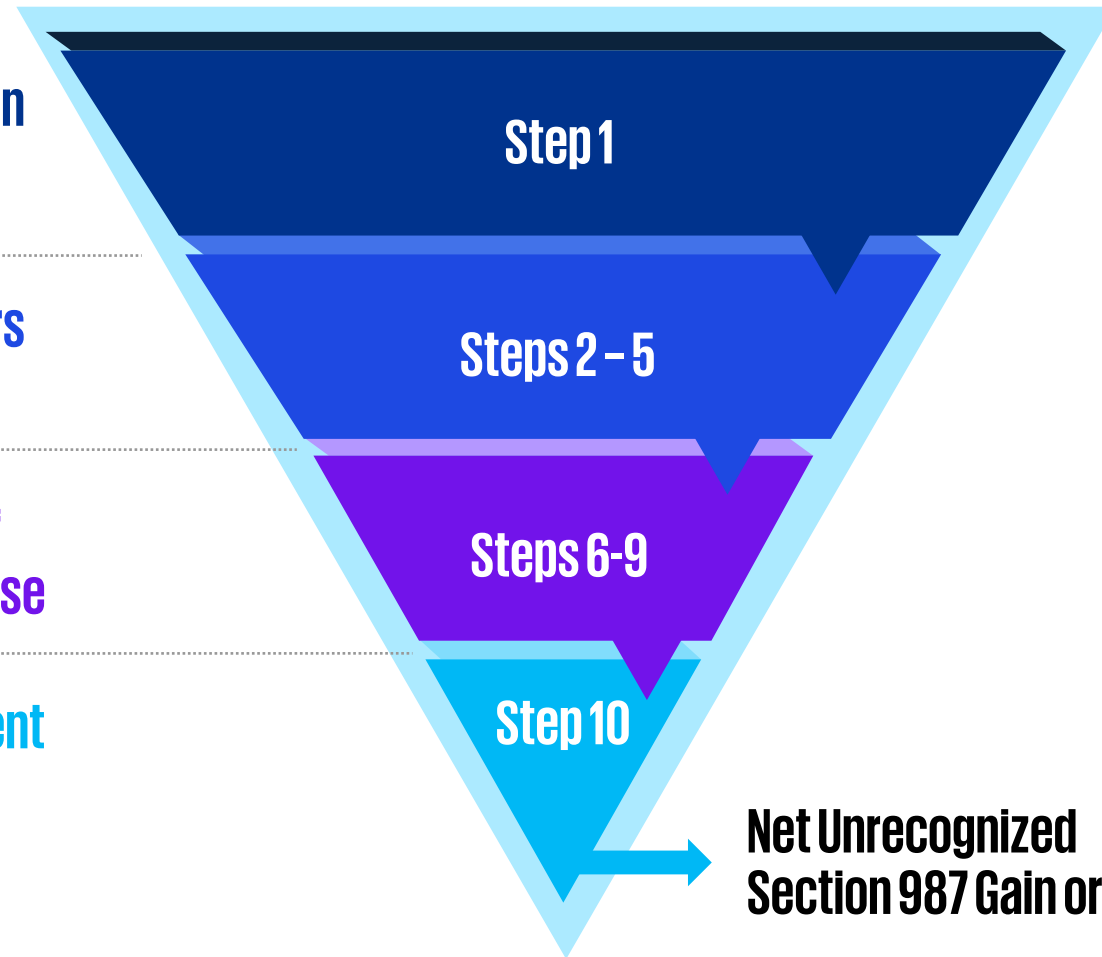
What makes the FEEP method challenging?

1. Tax basis balance sheet for each QBU

2. Historic rates for non-financial assets

3. Tracking each individual disregarded transaction between QBU and owner and QBUs of same owner

Recognition of 987 gain/loss

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

Accumulated Unrecognized 987 Gain or Loss	X	Remittance Proportion Remittance ÷ (Remittance + Gross Assets)	=	Recognized 987 Gain/Loss
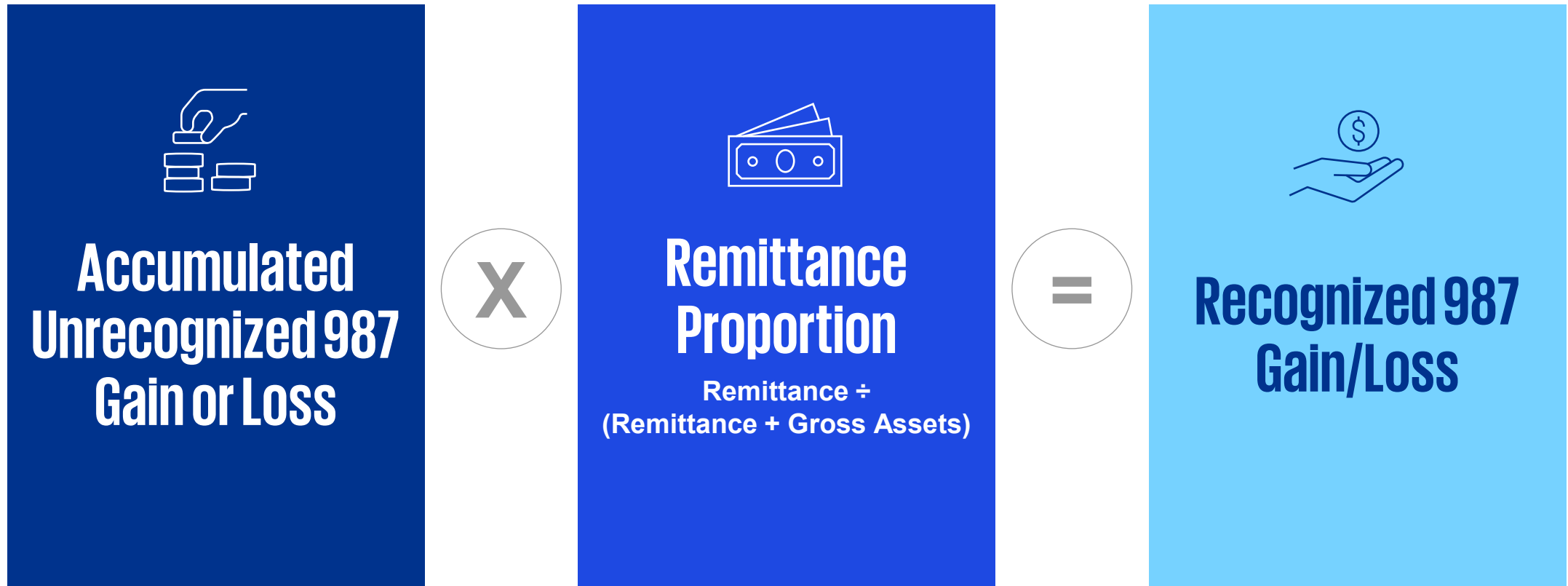
Sourcing and character

01

Assignment based on asset method

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

02

Assignment unrelated to underlying earnings

- Assignment is tied to balance sheet in year of remittance
- May not align with 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 assigned to FPHCI, election to treat as section 988 gain/loss that does not meet business needs

04
Elections

Election timing

All elections, including CRE and ARE, are subject to the following timing rules

> - Year of transition – with tax return filing
> - Any subsequent year – before the start of the applicable tax year
> - Only CRE, ARE, and 988 MTM can be revoked without consent of the Commissioner, but not within 60 months

Example: If calendar year taxpayer transitions on January 1, 2025

> - Elections to apply to tax year ending 12/31/2025
>   - Statements filed with tax returns by extended filing deadline of October 15, 2026
> - Elections to apply to tax year ending 12/31/2026
>   - Statements filed with IRS by 12/31/2025
> - Elections to apply to tax year ending 12/31/2027
>   - Statements filed with IRS by 12/31/2026

Section 987 elections summary

Section 987 elections	Summary of election	Revocable?
Election to amortize pretransition gain or loss (Reg. 1.987-10(e)(5)(ii))	• Election to recognize pretransition gain or loss over 10 years.	• No
Current rate election (Reg. 1.987-1(d)(2))	• Election to treat all assets and liabilities of a section 987 QBU as marked items.	• After 60 months: Yes • Within 60 months: Consent required
Annual recognition election (Reg. 1.987-5(b)(2))	• Election to recognize its net unrecognized section 987 gain or loss on an annual basis.	• After 60 months: Yes • Within 60 months: Consent required
Section 988 mark-to-market election (Reg. 1.987-3(b)(4)(ii))	• Election to recognize section 988 gain or loss attributable to a section 987 QBU under a mark-to-market method of accounting	• After 60 months: Yes • Within 60 months: Consent required
Section 987 grouping election (Reg. 1.987-1(b)(3)(ii))	• Election to treat all section 987 QBUs with the same functional currency as a single section 987 QBU.	• No
Election to use spot rate convention (Reg. 1.987-1(c)((1)(ii))	• Election to use a spot rate that reasonably approximates the spot rate determined under Reg. 1.988-1(d)(1), (2), and (4).	• No

*The Commissioner's consent to make or revoke an election may be obtained only with a ruling or administrative pronouncement. A copy of the consent must be attached to the required election statement.

Current rate election

Current rate election

Election results in calculation substantially similar over the life of the QBU to results under the 1991 Proposed Regulations

Simplified Translation

- Balance sheet items attributable of QBU translated at the year-end spot rate
- Income statement items translated using the average rate for the year

Loss Suspension Rules

- Losses on remittance suspended until gain with same source and character is recognized unless Annual Recognition Election is made

Additional Options and Considerations

- Alternative QBU NV: Option to determine w/o TBBS
- Net investment hedge of 987 QBU by same owner: adjustment to unrecognized section 987 gain/loss for the year
- Recurring transfer group election (proposed): ordinary business course transactions translated at average rate and not individually tracked

Loss suspension rules

Loss to the extent of gain rule

Section 987 losses recognized to the extent of section 987 gains of the same character and source

When losses are suspended

- Pretransition section 987 losses unless amortization election is made
- Section 987 loss realized when CRE (but no ARE) is in effect
- Section 987 loss on certain transactions within controlled group

When suspended losses are released

- Owner recognizes section 987 gain of the same source and character or platform is disposed off outside of controlled group
- Section 987 gain includes current year plus the three prior years (excluding pretransition years)

Elimination of losses

- Certain events may trigger recognition of suspended section 987 loss; however, suspended section 987 loss may be permanently lost in some instances (e.g., section 331 liquidation)

De minimis rule

- Section 987 loss less than $3M or 2% of gross income
- Threshold determined on controlled group basis

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Suspended loss de minimis rule

The loss suspension rules do not apply in a taxable year of an owner in which the total amount of section 987 loss of the owner and all members of the controlled group that would become suspended is less than the lesser of:

- $3 million; or

- 2% of the total amount of gross income of the owner and all members of the owner's controlled group for the taxable year.

- Controlled group means all persons related under section 267(b) or section 707(b)

- Threshold determined without respect to section 987 gain recognized in the year

Determine net unrecognized section 987 gain/loss to be recognized in current year

- Sum all section 987 loss amounts. If greater than threshold amount above, loss becomes suspended.

- Losses suspended in current year may offset current year section 987 gain

- For example, QBU 1's remittance results in $5M of section 987 loss and QBU 2's remittance results in $3M gain. QBU 1's loss is suspended but will offset $3M of the gain from QBU 2.

2024 proposed regulations
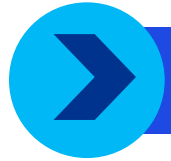
Proposed recurring transfer rule when current rate election in effect

- Certain assets transferred between a QBU and owner in recurring ordinary business course transactions can be translated at average rate for year
  - Qualifying transactions
    - Sales of inventory
    - Payments for services
    - Rents or royalties
  - Recurring group transfers disregarded for FEEP steps 2 and 3 unless using alternative QBU net value calculation

- Does not apply if more than 50% of total transfers happen in one quarter or more than 80% happen in two quarters
- **Note:** Net transfer relevant for purposes of determining remittance proportion

- Taxpayers may rely on this rule for tax years in which the 2024 Final Regulations apply, subject to consistency requirements

Example: Recurring transfer group election

US Corp

€30,000 payment for services

Services
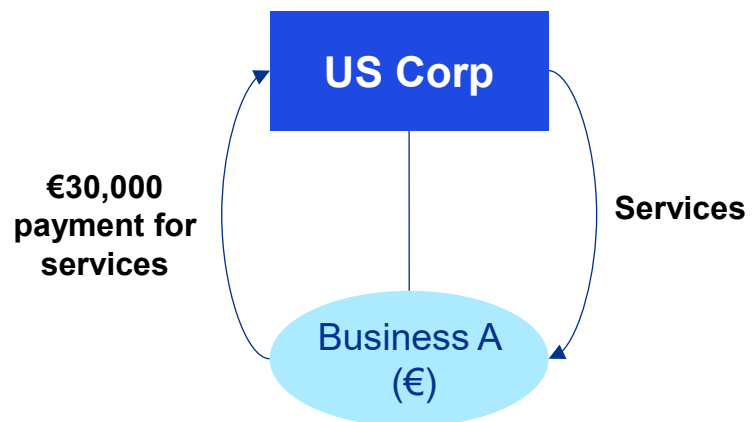
Business A (€)

Facts

- In year 1, US Corp provides services to Business A in exchange for arm's length cash payments
  - The payments are made in the ordinary course of the Business A trade or business.
- A current rate election and a recurring transfer group election are in effect for year 1. US Corp does not determine QBU net value with respect to Business A under the Alternative QBU Net Value method
- In year 1, Business A made 50 payments for services to DC1's home office, totaling €30,000x. Of this amount, Business A paid €5,000x in the first quarter of year 1, €7,500x in the second quarter of year 1, €10,000x in the third quarter of year 1, and €7,500x in the fourth quarter of year 1. No other transfers were made between Business A and DC1 for year 1.

Result

- No more than 50 percent of the total amount of grouped assets transferred in year 1 was transferred in any one quarter, and no more than 80 percent of the total amount of grouped assets transferred in year 1 in any two quarters.
- These transfers qualify as a recurring transfer group
- These transfers are disregarded for FEEP steps 2 and 3 and are translated at average rate for the year in FEEP step 10

Net investment hedge

- If a hedge qualifies as a **"section 987 hedging transaction"** section 988 gain or loss that would otherwise be recognized on the transaction is instead taken into account by adjusting the unrecognized section 987 gain or loss the QBU for the tax year by the amount of the hedge gain or loss (limited to a balance of zero)

- A **section 987 hedging transaction** is a hedge entered into by the owner of a section 987 QBU to manage the exchange rate risk with respect to the owner's investment in the QBU if the following requirements are met:

  - The hedge is clearly identified in the owner's books and records as a section 987 hedging transaction with respect to the hedged QBU (and only that QBU) on or before the day owner enters into hedge

  - A current rate election is in effect

  - Section 988 gain or loss of the owner with respect to the hedge is accounted for under a MTM method

  - Gain or loss on the hedge is be accounted for under GAAP as a cumulative foreign currency translation adjustment to shareholder's equity

  - The hedge is entered into by the owner of the hedged QBU (in the case of a consolidated group, hedge must be entered into by the member that owns the hedged QBU)

    - However, back-to-back hedges between related parties can qualify

Example: Net investment hedge
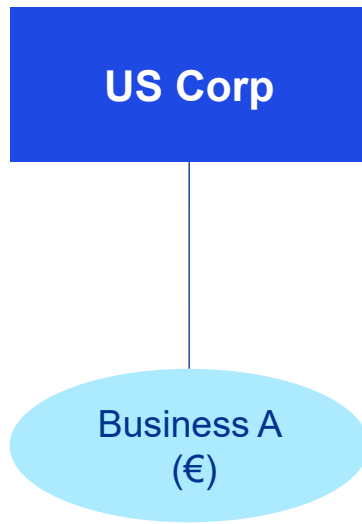
US Corp

Business A (€)

Facts

- US Corp enters into currency forward with external bank to manage FX risk related to Business A.

- The currency forward is properly identified and meets are requirements to qualify as a net investment hedge of Business A.

- The unrealized FX gain on the currency forward at the end of year 1 = $400

- The unrecognized section 987 loss with respect to Business A is $500

Result

- The hedge gain of $400 that would otherwise be recognized as section 988 gain first reduces the unrecognized section 987 loss to $100. No hedge gain remains to be recognized under section 988.

- If instead the hedge gain was $600, unrecognized section 987 loss is reduced to zero and section 988 gain of $100 is recognized.

Comparison of available methods

FEEP

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

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

Current Rate Election

+
- Less complex
- P&L computed at average rates
- Net investment hedge and ordinary course transaction elections available

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

Annual Recognition Election

+
- 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

Which elections should I make?

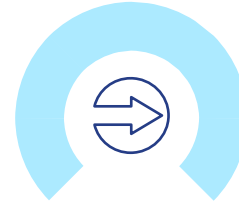**There is no one right answer:**

What types of assets and liabilities are on the balance sheet?

What is the foreign tax credit profile?

Do you have GILTI? Sub F?

Where would the section 987 gain/loss be assigned?

Will it impact your total tax cost?

What are the administrative costs of making or not making an election?

Do you maintain tax basis balance sheets?

How difficult is it to get the necessary information from local team?

Are there other accounting methods that may impact analysis?

What currencies are involved? Are they volatile or stable?

What are the disregarded cash/property flows? Frequent or sporadic?

What are the pretransition gains/losses? Where do they sit?

Section 987 model – Functionality

Methods and Elections

- Default FEEP calculation with tax basis balance sheet
- Current Rate Election
- Alternative QBU Net Value
- Alternative Remittance
- Annual Recognition Election

Scenario Planning

- Toggle elections and compare results
- Group QBUs by functional currency (FC)
- Remittances
- Terminations

Section 987 Attributes

- Calculate 987 gain/loss upon remittance
- Calculate and track deferred gain/loss and suspended losses
- Track three year look-back gains for suspended loss calc

Flexible Analysis

- QBU Attribute Reports
- Owner Result Reports
- Scenario Comparison Reports
- Income Statement and Balance Sheet Detail

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