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KPMG report: Qualified business units (QBUs), foreign currency gain or loss recognition and deferral (report on final regulations)

Final regulations (T.D. 9857) under section 987, from the U.S. Treasury Department and IRS and published in today's edition of the Federal Register, address combinations and separations of qualified business units (QBUs) and the recognition and deferral of foreign currency gain or loss in connection with certain QBU terminations and partnership transactions.

Specifically, these final regulations retain the temporary regulations set forth in Reg. sections 1.987-2T, 1.987-4T, and 1.987-12T (released in December 2016) as part of T.D. 9795. In addition, T.D. 9857 withdraws the temporary regulations regarding the allocation of assets and liabilities of so-called "section 987 aggregate partnerships" under Reg. section 1.987-7T. These temporary regulations were issued at the same time as the final regulations under section 987, the application of which has been deferred until 2020 for calendar-year taxpayers as announced in Notice 2018-57 to give the Treasury Department and IRS additional time to evaluate the compliance burden imposed by the final and temporary regulations. Notably, the Treasury Department decided to finalize certain of the temporary regulations while continuing to defer the applicability date of the broader package as those provisions remain subject to further study.

Read text of the [final regulations](#) [PDF 358 KB] as published in today's edition of the Federal Register. This report provides certain key highlights of the final regulations.

Reg. sections 1.987-2(c)(9) and -4(f)

Without modification, the final regulations adopt Reg. sections 1.987-2(c)(9)T and -4(f)T, which provide that section 987 gain or loss is not currently recognized when two or more section 987 QBUs (combining QBUs) with the same owner combine into a single section 987 QBU (combined QBU) or when a section 987 QBU (separating QBU) separates into multiple section 987 QBUs (each, a separated QBU).

Generally speaking, Reg. section 1.987-2 requires that assets and liabilities be attributed to a QBU to the extent such assets or liabilities are reflected on the QBU's separate set of books and records. Ordinarily, if these items cease to be maintained on the books and records of a QBU, a transfer of the items is deemed to occur between the section 987 QBU and its owner, resulting in the potential recognition of section 987 gain or loss. Reg. section 1.987-2(c)(9) provides that such a transfer will not be considered to occur if there is a combination of two or more QBUs owned directly by the same owner. Reg. section 1.987-2(c)(9)(i).

Likewise, under Reg. section 1.987-2(c)(9)(iii), the separation of a QBU into two separate QBUs owned by the same owner does not give rise to a transfer. Also, if the combination of QBUs results in a change in functional currency of one or more of the combining section 987 QBUs, any such change is treated as change in functional currency requiring the owner to make the adjustments required by section 985 and the regulations thereunder. Reg. section 1.987-2(c)(9)(ii).

Reg. section 1.987-4(f) contains the rules for calculating the net unrecognized section 987 gain or loss of a combined QBU (as defined in Reg. section 1.987-2(c)(9)(i)) and a separated QBU (as defined in Reg. section 1.987-2(c)(9)(iii)). For combined section 987 QBUs, the net unrecognized section 987 gain or loss is determined by taking into account the unrecognized section 987 gain or loss of the combining QBUs as if the combination occurred immediately before the tax year of the actual combination. A separated QBU's share of the separating QBU's net accumulated unrecognized section 987 gain or loss is determined by apportioning the separating QBU's net accumulated unrecognized section 987 gain or loss to each separated QBU in proportion to the aggregate adjusted basis of the gross assets properly reflected on the books and records of each separated QBU immediately before the separation.

Reg. section 1.987-12

As in the temporary regulations, Reg. section 1.987-12 generally defers section 987 gains or losses resulting from a "deferral event." In addition, section 987 losses are subject to further restriction if attributable to an "outbound loss event." When a deferral event occurs, the owner of the deferral QBU recognizes the section 987 gain or loss as determined under Reg. section 1.987-5, except that, solely for purposes of Reg. section 1.987-5, the assets and liabilities of the deferral QBU are deemed to stay on the books of the deferral QBU notwithstanding the deferral event. Accordingly, in the tax year of the deferral event, there is effectively no remittance with respect to these assets and liabilities, and therefore no currently recognized section 987 gain or loss. The original owner picks up the deferred section 987 gain and loss, but not until certain subsequent events—such as an actual net remittance or when the successor QBU's owner ceases to be a member of the controlled group. A deferral event includes a termination of the QBU, with certain exceptions such as when the owner is no longer a CFC or when the QBU ceases to engage in its trade or business. It may also include the disposition of a partial interest in a disregarded entity or section 987 aggregate partnership. In both cases, to be a deferral event, the assets and liabilities of the QBU must be reflected on the books and records of the so-called successor QBU, which generally means the books and records of a taxpayer in the same controlled group, and, in the case of certain termination events, when the original and new owner are domestic companies.

An outbound loss event is any termination of a section 987 QBU that occurs in connection with an outbound transfer to a foreign person that is a member of a controlled group or an outbound transfer of an interest in a section 987 aggregate partnership or disregarded entity through which the owner owns a section 987 QBU. Reg. section 1.987-12(d)(2). Similar to combinations and separations, the owner in an outbound loss event is treated as not having transferred the assets and liabilities of the outbound loss QBU, which means no section 987 loss is recognized in the tax year of the outbound loss transaction. Reg. section 1.987-12(d)(3). The deferred section 987 loss is recognized in the first tax year in which the owner or any qualified successor of the owner ceases to be a member of a controlled group that includes the related foreign person (or any qualified successor of the related foreign person).

It appears that Treasury decided to separate these regulations from the larger section 987 package in order to combat the perceived abuse on the part of taxpayers to selectively accelerate section 987 gains or losses in the context of related party transactions in which a QBU remains under common control, and the QBU assets continue to be used in the same trade or business activity.

Reg. section 1.987-7T

T.D. 9857 withdraws Reg. section 1.987-7T, which mandated a methodology for allocating the assets of a QBU held by a section 987 aggregate partnership to its partners based on the liquidation value of the partners' interests in the partnership. Until new regulations are proposed and finalized, taxpayers may use any reasonable method for determining a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through an aggregate section 987 partnership.

Effective dates and reliance

The rules governing QBU combinations and separations contained in Reg. sections 1.987-2(c)(9) and 1.987-4(f) generally apply to transactions that occur in tax years beginning on or after the day that is three years after the first day of the first tax year following December 7, 2016. For calendar-year taxpayers, this means that the rules will be effective on January 1, 2020 (absent any other delay in the effective date).

The rules governing deferral events and outbound loss events, as contained in Reg. section 1.987-12, apply to transactions that occur on or after January 6, 2017, as well as to any entity classification election resulting in such deferral or outbound loss event that is filed on or after January 6, 2017 (regardless of the date on which such election is effective). However, if the transaction resulting in the deferral or outbound loss event is undertaken with a principal purpose of recognizing a section 987 loss, the rule is effective for transactions occurring on or after December 7, 2016—30 days prior to the generally applicable effective date.

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