KPMG

# Determination under section 987 of taxable income or loss and foreign currency gain or loss with respect to a qualified business unit (QBU)

## Analysis and observations of final and proposed regulations

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# Contents

# Introduction

The U.S. Department of the Treasury and IRS (collectively, "**Treasury**") on December 10, 2024, released final regulations (the "**2024 Final Regulations**") and proposed additional regulations (the "**2024 Proposed Regulations**") under section 987. The 2024 Final Regulations implement the foreign exchange exposure pool (**FEEP**) method proposed in the regulations released by Treasury on November 9, 2023 (the "**2023 Proposed Regulations**")[1] with several noteworthy changes discussed herein.

Section 987 applies when an "eligible QBU"[2] has a different functional currency than its regarded owner (a "**section 987 QBU**"). The FEEP method calculates unrecognized section 987 gain or loss for the tax year using a tax basis balance sheet approach to measure the annual change in net value of the section 987 QBU that is attributable to certain assets and liabilities ("**marked items**") of the QBU that are economically exposed to fluctuations in foreign currency. The first step of the FEEP method computes the change in the net value of the QBU in the owner's functional currency (**OFCNV**) from the prior year by translating marked items on the year-end balance sheet at the spot rate; items other than marked items are "**historic items**" and are translated at their applicable historic exchange rate. The remaining steps isolate the change in OFCNV that is solely attributable to foreign currency gain or loss by adjusting for taxable income or loss of the QBU, tax-exempt and nondeductible items, contributions, and distributions. Section 987 gain or loss of an owner is generally recognized (subject to the deferral and loss suspension rules described below) when the section 987 QBU has made a remittance to the owner over the course of the tax year, which requires a tracking and translation of all disregarded transfers between the owner and the section 987 QBU.

In addition to the FEEP method, the 2024 Final Regulations include the current rate election (**CRE**)—with significant modifications from the 2023 Proposed Regulations—which modifies the FEEP method by translating all items on the section 987 QBU's balance sheet at the year-end spot rate, eliminating the need to track historic translation rates for historic items, but bringing all assets and liabilities of the QBU within scope of section 987 and subjecting the owner to the loss suspension rules (discussed below). The 2024 Final Regulations also include an annual recognition election (**ARE**), which requires recognition of unrecognized section 987 gain or loss on an annual basis and turns off application of the loss suspension rules to post-transition section 987 losses if made contemporaneously with the CRE. Read a KPMG report (November 2023) for a discussion of the regulatory history of section 987, an overview of the FEEP method, and a detailed discussion of the elections proposed therein.

As proposed in the 2023 Proposed Regulations, the 2024 Final Regulations generally apply to tax years beginning after December 31, 2024. During the first applicable tax year (the "**Transition Year**"), taxpayers are permitted to make any relevant section 987 elections by filing a statement with the return; however, if an election is not made in this first applicable tax year, the election must be filed with the IRS before the start of the tax year to which the election will apply.

The 2024 Proposed Regulations would include an election to simplify the translation of certain ordinary course business transfers involving inventory, services, rents, or royalties between a section 987 QBU and its owner ( discussed in more detail below) that can be made when a CRE is in effect. The 2024 Proposed Regulations would apply to tax years beginning after the date they are published as final regulations in the Federal Register. Taxpayers can rely on the 2024 Proposed Regulations in their entirety for tax years in which the 2024 Final Regulations apply to them, subject to consistency requirements within their consolidated group and section 987 electing group. Taxpayers may separately rely on portions of the

[1] 88 F.R. 78134.
[2] An "eligible QBU" is a "qualified business unit" that is not subject to the United States dollar approximate separate transactions method rules of Treas. Reg. § 1.985–3. For this purpose, a "qualified business unit" is defined in the 2024 Final Regulations by reference to Treas. Reg. § 1.989(a)–1(b), except that a corporation, partnership, trust, estate, or disregarded entity is not itself a qualified business unit, but the activities of the entity may be a qualified business unit.

regulations proposed on December 8, 2016 (“the **2016 Proposed Regulations**”)[3] that were not withdrawn or finalized for tax years in which the 2024 Final Regulations apply to them, subject to the same consistency requirement within their consolidated group and section 987 electing group.

### KPMG observation

Under the 2023 Proposed Regulations, taxpayers would have faced substantial compliance burdens under the FEEP method. First, a tax basis balance sheet would need to be maintained for each section 987 QBU, including those owned by CFCs. Additionally, if a CRE were not made, taxpayers would have had to track historic translation rates for all historic assets of a section 987 QBU in order to compute taxable income or loss of the section 987 QBU as items related to those assets, such as depreciation, would be translated into the owner’s functional currency each year based on the historic rate. Finally, the date of each disregarded transaction between a section 987 QBU and its owner (or another section 987 QBU of the owner) would be required to be tracked and properly translated at the appropriate spot or historic rate (depending on the whether the item transferred was marked or historic) for purposes of determining a QBU’s unrecognized section 987 gain or loss each year and whether the section 987 QBU had made a remittance. As described in detail below, the 2024 Final Regulations and 2024 Proposed Regulations provide alternative calculations and elections that greatly simplify the compliance burden when a CRE is made.

# Notable changes to the 2023 Proposed Regulations in the 2024 Final Regulations

## Entities in scope of the 2024 Final Regulations

- The 2024 Final Regulations apply to individuals and corporations, other than individuals that are not U.S. persons and foreign corporations that are not controlled foreign corporations (**CFCs**) or that are CFCs in which no U.S. Shareholders (within the meaning of section 951(b)) own stock (within the meaning of section 958(a)). However, in the preamble to the 2024 Proposed Regulations, Treasury requested comments regarding whether the application of section 987 to CFCs should be further modified.

- The 2024 Final Regulations do not apply to trusts and estates and additional guidance on how section 987 should apply is expected in the future.

- The 2024 Final Regulations do not generally apply to partnerships but state that taxpayers must apply sections 987 and 989(a) to partnerships and eligible QBUs owned by partnerships using a reasonable method (e.g., the aggregate approach, entity approach, or hybrid approach), subject to consistency requirements among related parties. Regardless of the specific method, as discussed in more detail below, provisions of the 2024 Final Regulations related to the suspension of section 987 loss, deferral of section 987 gain or loss on certain transactions, determination of source and character, and reporting requirements apply.

- The 2024 Final Regulations apply to specified entities (i.e., banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts). To facilitate compliance with these regulations by specified entities, Treasury

[3] 81 F.R. 88882.

modified the definition of a "marked item" to include section 988 transactions of the QBU and common items in the insurance industry, such as insurance reserves and separate account assets that support variable insurance contracts. Additionally, how a QBU calculates a remittance was modified, and rules for hedging transactions were added. These changes are discussed in detail below.

# Transition rules

- Consistent with the 2023 Proposed Regulations, an owner of a section 987 QBU computes "pretransition gain or loss" as of the day before the Transition Date (i.e., as of December 31, 2024 for calendar year taxpayers, except in the case of a terminating QBU (discussed immediately below)) under its existing section 987 method, if such method is an "eligible pretransition method", or under the "simplified FEEP" method (described below), if not. The 2024 Final Regulations include helpful changes to the definition of "eligible pretransition method." Under the 2023 Proposed Regulations, pretransition gain was treated as net accumulated unrecognized section 987 gain of the section 987 QBU, whereas pretransition loss was treated as suspended loss and was subject to the loss suspension rules described below. These rules were finalized as proposed, except that, if a CRE and not also an ARE is in effect for the Transition Year, pretransition losses are treated as net accumulated unrecognized section 987 loss. Alternatively, taxpayers can make an election (the "**Amortization Election**") to amortize their net pretransition gain or loss over ten years beginning on their Transition Date.

> **KPMG observation**
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> A taxpayer does not avoid the application of the suspended loss rules with respect to pretransition losses when a CRE, but not an ARE, is in effect. Instead, when the section 987 QBU makes a remittance, any section 987 loss of the QBU that would otherwise be recognized will become suspended under the loss suspension rules as applied when a CRE, but not an ARE, is in effect. In addition, if a taxpayer subsequently decides to also make an ARE or revoke its CRE, unrecognized section 987 losses of its section 987 QBUs become suspended losses at such time. However, the ultimate amount of section 987 losses that become suspended is subject to change based on currency fluctuations after the Transition Date.

- **Terminating QBUs[4]:** The 2024 Final Regulations apply to a terminating QBU immediately before its termination. As such, the terminating QBU should calculate its pretransition gain or loss immediately prior to termination and recognize, defer, or suspend section 987 gain and loss in connection with its termination in accordance with these regulations.
  - The loss suspension rules described in the next section below apply to pretransition loss of a terminating QBU. During the period between the terminating QBU's termination and the 2024 Final Regulations becoming generally applicable to the other QBUs of the owner (January 1, 2025, for calendar year taxpayers), the owner applies section 987 with respect to its other QBUs under its existing method and releases suspended loss from the terminating QBU to the extent the owner recognizes section 987 gains from its other QBUs that have the same source and character under its existing method. (The gains also need to be in the same subpart F income group or tested income group if the owner is a CFC.)
  - When the 2024 Final Regulations become generally applicable to the owner and the owner makes the Amortization Election in its Transition Year, any remaining suspended loss or pretransition gain of the terminating QBU is subject to amortization.

[4] A terminating QBU is a defined as a section 987 QBU that terminated on or after November 9, 2023 (or before that date as a result of a check-the-box election filed on or after such date) that had not previously adopted the FEEP method.

- **Small business election**: The 2024 Final Regulations allow owners that would qualify for the small business exemption under section 163(j)(3) (gross receipts of $25 million or less) to elect to treat all QBUs that meet a $10 million asset threshold as having no pretransition gain or loss. The asset test is applied by grouping all QBUs of the controlled group by country.

- **Eligible pretransition method**: The 2024 Final Regulations broaden the definition of an "eligible pretransition method" to reflect Treasury's intention to include any method that reasonably complies with the statutory requirements of section 987. However, to qualify as an eligible method, the owner must have applied the eligible pretransition method on a return filed before November 9, 2023. In addition, for an earnings-only method to be eligible, the method must have been applied consistently and reasonably to all QBUs of the owner in each year from the first tax year the method applied. The preamble to the 2024 Final Regulations reiterates that relying on the currency translation adjustment (**CTA**) determined under U.S. generally accepted accounting principles (**U.S. GAAP**) is not a reasonable method.

- **Reasonable conventions**: The changes confirm that an eligible method may include the use of reasonable conventions, such as using an average exchange rate for frequent and recurring transfers (rather than using the spot rate for each individual transfer). In addition, an eligible method may include a consistent practice of disregarding certain transfers between a QBU and its owner (or other QBUs of its owner) in determining a remittance, so long as the transfers were accounted for in a reasonable manner. For example, the disregarded transfers may have increased or decreased equity and basis pools because it was included in the QBU's taxable income. However, an eligible method does not include a consistent practice of disregarding transfers that would have been treated as distributions if the QBU were a corporation.

## KPMG observation

The ability to rely on a consistent practice of disregarding routine transfers between a section 987 QBU and its owner (or other QBUs thereof) will be a welcome clarification for taxpayers that operate in foreign jurisdictions through U.S.-owned branches and disregarded entities. Many U.S. corporations have treated routine transactions with their foreign branches, such as intercompany lending, services, and sales, as generating taxable income or loss of the section 987 QBU, rather than as a remittance. While the 2024 Final Regulations will treat disregarded transactions as transfers that must be taken into account in determining a section 987 QBU's remittance post-transition, it is helpful that a taxpayer's historic position in this regard does not cause their section 987 method to be considered an ineligible method for calculating pretransition gain or loss.

- **Errors**: Additionally, the 2024 Final Regulations clarify that neither errors in applying the method (so long as the error is corrected in determining pretransition gain or loss) nor failure to apply the method to all tax years of the QBU are disqualifying.

- **Ineligible pretransition method**: Taxpayers that were not on an eligible pretransition method must compute pretransition gain or loss under the "simplified FEEP" method. The simplified FEEP method condenses the ten-step calculation into two steps. The first step computes the change in OFCNV by translating the entire year-end tax basis balance sheet at the spot rate. The second step (or tenth step under the regular FEEP method) computes a residual adjustment, which is the annual change in net value determined in the QBU's currency translated at the average rate for the year. The amount in step two is subtracted from the amount in step one and is treated as the annual section 987 gain or loss. The accumulated balance across all years less any section 987 gain or loss already recognized by the taxpayer becomes pretransition gain or loss.
  - As proposed, taxpayers would have been required to apply the simplified FEEP method for all years in which the QBU was in existence. The 2023 Proposed Regulations would have also required taxpayers to prepare a tax basis balance sheet for all relevant years.

The 2024 Final Regulations add a limit to the relevant years and requires calculations for all tax years beginning on or after September 7, 2006 (rather than for tax years going back to the year of QBU formation). Since the pretransition gain or loss is computed as if a CRE were in effect, the calculation is further simplified due to changes in how the change in OFCNV is determined when a CRE is in effect that enable taxpayers to comply with the method without the need for a tax basis balance sheet (described below).

- **Transition exchange rate**: Under the 2023 Proposed Regulations, upon transition, taxpayers generally would have reset their balance sheet, and the historic rate for all historic assets would have become the spot rate on the day before their Transition Date (the "**Transition Rate**"). Taxpayers that had applied an earnings-only pretransition method pursuant to which they translated distributions out of their capital pools (when the earnings pool was zero or less) into the owner's functional currency at the historic rate would have made an adjustment to their pretransition gain or loss to reflect this change in measuring their capital pool, causing the built-in gain or loss in the capital pool (i.e., the difference between the historic and Transition Rate as applied to the basis of the capital pool) to become subject to section 987. Under the 2024 Final Regulations, taxpayers on such a method that do not make a CRE would continue to use the historic rate that applied to these assets and no adjustment is made to their pretransition gain or loss. However, for taxpayers that make a CRE, currency gain or loss on the QBU's capital is taken into account in determining pretransition gain or loss.

### KPMG observation

This change may be welcome by taxpayers on an earnings-only method if they had significant gain or loss with respect to assets in the capital pools of their section 987 QBUs that would have been recharacterized as pretransition gain or loss under the 2023 Proposed Regulations. Under the 2024 Final Regulations, any such gain will instead be recognized as taxpayers dispose of these assets (as the taxpayer's adjusted basis measured at the historic rate would be less than its adjusted basis measured at the Transition Rate), and taxpayers may not plan to do so at any point in the near future. Similarly, taxpayers with a built-in loss in these assets may have been materially disadvantaged if that loss had become suspended pretransition loss. However, for taxpayers with a large number of historic assets acquired over a large period of time, tracking the individual historic rates for each asset held pretransition could greatly exacerbate the complexity and compliance burden of the FEEP method.

## Loss suspension rules

- **Suspended losses:** Under the 2023 Proposed Regulations, pretransition section 987 loss would become suspended loss unless the taxpayer made the Amortization Election. In addition, amortization would cease with respect to pretransition section 987 loss that was subject to the Amortization Election when the relevant owner entered into an inbound or outbound section 381(a) transaction (while pretransition gains would have been triggered immediately prior to the transaction) and such loss would become suspended loss. Further, section 987 losses that would otherwise be recognized would generally become suspended losses if accumulated while a CRE was in effect and an ARE had not simultaneously been in effect.

- Such suspended losses would be recognized in the year they become suspended or a subsequent tax year to the extent the owner recognized section 987 gain of the same source and character ("**loss-to-the-extent-of-gain rule**") or if the QBU terminated without a successor QBU owned by a member of its controlled group (e.g., if the trade or business was sold to an unrelated party). However, suspended section 987 losses would be permanently lost in certain circumstances, such as in connection with a section 331 liquidation, an inbound section 332 liquidation, or an inbound section 381(a) transaction. For purposes of the loss suspension rules, all members of the consolidated group are treated as a single owner.

These provisions were generally finalized by the 2024 Final Regulations, with the following changes:

- **New de minimis rule**: The loss suspension rules do not apply if the losses that would be subject to suspension in the tax year do not exceed the lesser of $3 million or 2% of gross income. The threshold is determined on a controlled group basis.
- **New look-back rule:** For purposes of applying the loss-to-the-extent-of-gain rule, the section 987 gain recognized includes the current year gain and, generally, the net section 987 gain recognized for the prior three tax years. Tax years beginning before the Transition Date are not included in the three-year lookback period.
- **Anti-abuse rule:** A section 987 gain that is recognized with a principal purpose of reducing the U.S. federal income tax liability of the owner (including over multiple tax years) is disregarded for purposes of the loss-to-the-extent-of-gain rule. The regulatory text uses an example of a taxpayer that recognizes section 987 gain in a year when the tax on the gain is offset by an expiring tax attribute solely for the purpose of releasing suspended loss in the following year.
- **SRLY:** The 2024 Final Regulations apply the principles of Treas. Reg. § 1.1502-21(c) to suspended losses of an owner arising in a separate return limitation year ("**SRLY**") that joins a consolidated group. The limitation is determined by reference to the member's items of section 987 gain or loss overall (i.e., a separate limitation is not determined for U.S. source items and foreign source items in each separate section 904 category).

# Provisions applicable to partnerships and S corporations

In the description immediately below, references to "partnerships" should be read as references to "partnerships and S Corporations."

- **Aggregate vs. entity treatment:** While the 2024 Final Regulations do not apply comprehensively to partnerships, section 987 must be applied to partnerships and their eligible QBUs in a reasonable manner and all members of the same controlled group must apply the same method consistently with respect to a particular partnership. In this regard, the preamble and the 2024 Final Regulations provide the following examples as potential applications of section 987 in the context of a domestic corporate partner ("**USD Partner**") in a partnership that would use the euro (**EUR**) as its functional currency if it were treated as a *per se* QBU under section 989(a) for purposes of section 987 ("**EUR Partnership**") and that operates a QBU with the Swiss franc (**CHF**) as its functional currency (**CHF QBU**):
    - Under an entity approach, the CHF QBU would be treated as a section 987 QBU of the EUR Partnership and the EUR Partnership would be treated as a section 987 QBU of the USD Partner.
    - Under an aggregate approach, the USD Partner would treat each separate trade or business of the EUR Partnership as a section 987 QBU of the USD Partner. Thus, the USD Partner would be the indirect owner of the CHF QBU. The EUR Partnership itself would not be treated as a section 987 QBU of the USD Partner.
    - Under a hybrid approach introduced in the 2023 Proposed Regulations, the EUR Partnership would apply section 987 in a reasonable manner to the CHF QBU and allocate the resulting unrecognized section 987 gain or loss to the USD Partner on an annual basis such that unrecognized section 987 gains or losses of the CHF QBU would not transfer to a new partner if the USD Partner transferred its interest in the EUR Partnership.

- **Applicable provisions:** The provisions of the 2024 Final Regulations relating to the determination of source and character of section 987 gain or loss, certain reporting requirements, the deferral of section 987 gain or loss on certain related party terminations (as contained in Treas. Reg. § 1.987-

12), and the loss suspension rules (modified as discussed immediately below) apply to an eligible QBU operated by a partnership. An ARE and a section 988 mark-to-market election can be made with respect to a partnership.

- **Modified loss suspension rule:** Partnerships and their partners are subject to a modified version of the "loss suspension" rules contained in the 2024 Final Regulations that operates differently depending on the specific approach that is applied with respect to the partnership and the QBUs it operates.
    - Under either an aggregate or entity theory, when an eligible QBU is directly owned by a partnership, any section 987 loss of a QBU that would be recognized is suspended. If an aggregate approach is being applied, the loss-to-the-extent-of-gain rule takes into account other section 987 gains of the partner earned outside of the partnership. Under an entity approach, the partnership itself would apply the loss-to-the-extent-of-gain rule.
    - If the partner treats the partnership itself as a section 987 QBU, then loss suspension applies if the partnership is 95% owned by related persons.
    - **Exception to loss suspension rule:** Loss suspension rules would not apply if (1) the partner or partnership consistently applied a method that did not result in section 987 gain or loss on historic assets of the eligible QBU (e.g., the FEEP method); (2) an ARE is in effect; or (3) the de minimis rule applies (see further discussion of the de minimis rule above).

# Provisions applicable to consolidated groups

- The 2024 Final Regulations finalized the treatment of intercompany transactions between a section 987 QBU of a consolidated group member and another member of the group provided in the 2023 Proposed Regulations. Treas. Reg. § 1.1502-13(j)(9) treats such transactions as two separate transactions: a transaction between the section 987 QBU and its owner and an additional transaction between the owner and the other member. While the 2024 Final Regulations follow the approach of the 2023 Proposed Regulations, the 2024 Final Regulations add additional examples illustrating this rule, including when the underlying transaction is sold to a non-member.

# Determination of recognized section 987 gain or loss

- **Remittance proportion**: Subject to the loss suspension and deferral rules contained in Treas. Reg. §§ 1.987-11, 1.987-12, and 1.987-13, the owner of a section 987 QBU recognizes section 987 gain or loss upon a remittance. A remittance is the excess of amounts transferred by the section 987 QBU to the owner over the amounts transferred by the owner to the section 987 QBU. The amount recognized is equal to the unrecognized section 987 gain or loss of the remitting QBU, as of the last day of the year, multiplied by the remittance proportion, which represents the proportion of gross assets that were transferred to the owner.
    - The 2023 Proposed Regulations would have determined remittances and remittance proportion by reference to the owner functional currency and would have required translating each transfer by the section 987 QBU into the owner's functional currency using the appropriate rate for each relevant transfer.
    - Under the 2024 Final Regulations, remittances and the remittance proportion are both determined by reference to the QBU's functional currency. As such, it is no longer necessary to translate each individual transfer from the QBU into the owner's functional currency to determine if there has been a remittance. However, each transfer from the owner to the section 987 QBU must be translated into the section 987 QBU's functional currency.
    - Further, the 2024 Final Regulations allow for an alternative calculation of the remittance ("**Alternative Remittance Calculation**") that does not require tracking each separate transfer made throughout the year. Under the alternative formulation, the remittance amount can be calculated based on the change in QBU net value and adjusted by the taxable income or loss of the QBU, tax-exempt income, and non-deductible expenses.

**KPMG observation**

Although the Alternative Remittance Calculation offers relief from tracking and translating each separate transfer made throughout the year for purposes of determining a section 987 QBU's remittance, such tracking and translating is still required for purposes of determining unrecognized section 987 gain or loss under the FEEP method. See the discussion below on the 2024 Proposed Regulations, which would obviate the need for individually tracking and translating certain routine transfers of a taxpayer that makes a CRE and would qualify for this election.

# Modifications to the calculation of section 987 gain or loss when a CRE is in effect

- The 2024 Final Regulations included several changes that apply if a CRE is in effect.
  - **Hedging transactions**: New rules align gain or loss on an owner's net investment hedge of a QBU with the unrecognized section 987 loss or gain of the hedged QBU for the tax year. If the hedging transaction meets certain criteria, the owner adjusts the unrecognized section 987 gain or loss of the QBU for the tax year by the amount of the hedge gain or loss (limited to a balance of zero). The hedge must be properly identified on or before the end of the day on which it is entered into and each hedge must apply to only one section 987 QBU (which may include more than one section 987 QBU of the same owner that have the same functional currency if the owner has elected to treat such section 987 QBUs as a single section 987 QBU for purposes of section 987 under the QBU grouping election). Additionally, the hedge must be subject to mark-to-market accounting for U.S. federal income tax purposes and accounted for in CTA under U.S. GAAP. Finally, the hedge must be entered into by the owner of the QBU.

**KPMG observation**

To qualify as a hedging transaction, the owner of the QBU must enter into the hedge. For this purpose, all members of a consolidated group are not treated as a single owner (although Treasury notes that it is considering whether such treatment is appropriate). Helpfully, the owner may enter the hedge with a related or unrelated party. Therefore, if a multinational group enters into third party hedges through a treasury center, the treasury center must enter into a back-to-back hedge with the owner of the QBU in order for the hedge to qualify.

  - **Alternative calculation of QBU net value:** The 2024 Final Regulations provide an alternative formula to determine a QBU's net value ("**Alternative Net Value Formula**") - which is relevant for computing the change in OFCNV in step 1 of the FEEP method - that would not require maintaining a tax basis balance sheet. To determine the ending QBU net value, the beginning QBU net value is adjusted for the transfer of assets and liabilities between the QBU and the owner, and then further adjusted by the taxable income or loss, tax-exempt income, and non-deductible expenses of the QBU (all determined in the QBU's functional currency).
    - For all years the CRE is in effect, the QBU net value should be calculated consistently using either the adjusted tax basis balance sheet or Alternative Net Value Formula.

**KPMG observation**

By adding the Alternative Net Value Formula, Treasury provides a method that is similar to the method proposed in the 1991 regulations but limits recognition of section 987 loss unless an ARE is in effect when such losses accumulate. The Alternative Net Value Formula for calculating unrecognized section 987 gain or loss is necessarily mutually exclusive with the Alternative Remittance Calculation because the Alternative Net Value Formula requires tracking each transfer made between the QBU and its owner, whereas the Alternative Remittance Calculation avoids this by relying on a tax basis balance sheet. As such, a taxpayer making a CRE would need to choose between preparing a tax basis balance sheet for its section 987 QBUs or tracking the transfers between the QBU and owner. However, the 2024 Proposed Regulations would provide additional simplifications in this regard, as described in more detail below.

## Source and character of section 987 gain or loss

- **Subpart F income:** Consistent with the 2023 Proposed Regulations, the 2024 Final Regulations determine the source and character of section 987 gain or loss using the asset method of Treas. Reg. §§ 1.861-9(g) and 1.861-9T(g). However, under the 2024 Final Regulations, section 987 gain or loss that is allocated and apportioned to subpart F income is assigned to the same subpart F income group as the underlying asset. For example, if a QBU holds assets that generate "foreign personal holding company income" ("**FPHCI**") in the income group consisting of dividends, interest, rents, and royalties, the section 987 gain or loss will be allocated and apportioned to such group. Under the 2023 Proposed Regulations, all section 987 gain or loss allocated and apportioned to subpart F income would have been treated as section 988 gain or loss not directly related to the business needs of the CFC. The 2024 Final Regulations provide a limited scope election to treat section 987 gain or loss that is allocated to FPHCI as section 988 gain or loss that does not meet business needs in order to facilitate netting of section 987 gains and losses with other foreign currency gains and losses of the CFC and to avoid the need to track multiple income groups. Section 987 gain or loss subject to this election is not treated as section 988 gain or loss for the purpose of making other elections that apply to actual section 988 gain or loss (e.g., it is not eligible for the business needs exception because the item was allocated to FPHCI in the first instance to be eligible for the election).

## Section 988 transactions of a section 987 QBU

- **Determined by reference to the QBU:** The 2024 Final Regulations did not finalize the proposal that would have determined whether a transaction was a section 988 transaction by reference to the QBU's functional currency but calculated section 988 gain or loss by reference to the owner's functional currency. The existence of a section 988 transaction, and the calculation of gain or loss, is determined solely by reference to the QBU's currency and section 988 transactions of a section 987 QBU may include transactions denominated in the owner's functional currency. Section 988 transactions of the QBU are now treated as marked items under the 2024 Final Regulations.

- **Mark-to-market election:** The 2024 Final Regulations provide an election to recognize section 988 gain or loss of a section 987 QBU under a mark-to-market method of accounting, subject to consistency requirements. An anti-abuse rule will result in a section 988 transaction being attributed to or away from a section 987 QBU if the section 988 transaction was entered into with a principal purpose of generating offsetting amounts of section 988 and 987 items. Additionally, an "anti-stuffing" rule disallows the election with respect to a section 988 transaction that is contributed to a section 987 QBU with a built-in loss if the transaction was not subject to mark-to-market accounting by the transferor.

**KPMG observation**

By rejecting the proposed rules with respect to section 988 transactions, Treasury eliminated a significant potential compliance burden of maintaining completely separate section 988 calculations that a taxpayer would not otherwise maintain. Further, including section 988 transactions of a section 987 QBU as a marked asset reduces the number of items that an owner would have to track on a historic basis. These changes are particularly helpful to owners with significant section 988 transactions in their business, such as banks.

# 2024 Proposed Regulations

- As described above, in order to calculate unrecognized section 987 gain or loss each year, the FEEP method for calculating unrecognized section 987 gain or loss generally requires an owner to track all transfers between it and its section 987 QBU, translated at the appropriate rate. Under the FEEP method, transfers of historic assets are translated at the applicable historic rate, while transfers of marked assets are translated at the spot rate on the date of transfer. In lieu of using the actual spot rate that applies to each individual transfer of a marked asset, a "**spot rate convention**" election is available that would allow the same rate to be used for a period of up to three months.While the Alternative Remittance Calculation would not require tracking and translating transfers for the remittance calculation, it does not alleviate this burden for the calculation of unrecognized section 987 gain or loss.

- **Recurring transfer group election:** If a CRE is in effect, the 2024 Proposed Regulations would provide an election for recurring transfers (the "**recurring transfer group election**") whereby taxpayers would translate certain assets that are transferred between a QBU and its owner as part of recurring ordinary business course transactions at the average rate for the year, rather than the appropriate rate on the date of transfer. Individual transfers of these assets would not need to be tracked in order to compute section 987 gain or loss.
  - The election would be limited to frequently occurring transfers between a section 987 QBU and its owner (or another QBU of the owner) made in the ordinary course of a trade or business in connection with sales of inventory, payments for services, or rent or royalty transactions and requires arm's length compensation to be paid. If the taxpayer uses the Alternative Remittance Calculation, the taxpayer would not need to maintain records with respect to transfers of grouped assets because such individual transfers would not be relevant to either the calculation or recognition of section 987 gain or loss.
  - The election would not apply if more than 50% of the total amount transferred occurs during one quarter or more than 80% occurs during two quarters. The election would not apply to transfers that would be distributions or contributions to capital if the QBU were a corporation.

- The 2024 Proposed Regulations would apply to tax years beginning after the date they are published as final in the Federal Register.
  - Subject to general consistency and timing requirements of other section 987 elections, taxpayers may rely on the 2024 Proposed Regulations to make the recurring transfer group election for tax years in which the 2024 Final Regulations apply.
  - Comments are requested as to whether intercompany lending transactions of financial entities should be included in a recurring transfer group.

**KPMG observation**

With the modifications in the 2024 Final Regulations and 2024 Proposed Regulations, taxpayers may find the CRE significantly more appealing than as initially proposed. Under the 2023 Proposed Regulations, the CRE simplified the FEEP method by treating all balance sheet items as marked items (translated at year-end spot rate) and translating taxable income using the average exchange for the year. The election, however, did not eliminate the need to establish a tax basis balance sheet nor did it alleviate the need to track each transfer between the QBU and its owner (or QBUs of the owner) and to translate each transfer using the spot rate applicable to the date of each transfer. Even with the use of a spot rate convention to translate all transfers within a quarter using a single rate, the limited simplification may not have been a benefit that outweighed the cost of the loss suspension rules or subjecting itself to the ARE to avoid the loss suspension rules.

Now, under the 2024 Final Regulations and the 2024 Proposed Regulations, the CRE provides a significantly simplified methodology. The owner could rely on the Alternative Net Value Formula and avoid maintaining a tax basis balance sheet for the section 987 QBU in applying the FEEP method or make the recurring transfer group election and apply the Alternative Remittance Calculation to reduce the number of transactions that need to be tracked if its transfers relate to inventory, services, rents, or royalties. In addition, any pretransition loss would not immediately become suspended and would instead reduce the pool of future accumulated unrecognized section 987 gain or loss of the QBU. This provision would avoid the potential character and source mismatches between the transition year and a future year when section 987 gain is recognized. With these additional levers, owners may conclude that they are willing to suspend losses upon a remittance in exchange for the simplicity.

- In addition, the preamble to the 2024 Proposed Regulations provides that, for years in which the 2024 Final Regulations apply to them, taxpayers may continue to rely on the rules proposed in the 2016 Proposed Regulations that have not been withdrawn, subject to a consistency requirement, related to QBUs that use the U.S. dollar as their functional currency and the deferral of certain section 988 losses from related parties.

# Requests for comments

The preamble to the 2024 Proposed Regulations requests comments on a number of unresolved questions and open issues and specifically regarding the following topics, many of which are discussed in greater detail above, by March 11, 2025:

- Whether section 987 should be applied with respect to partnerships under an entity, aggregate, or hybrid approach
- Whether a partnership should be treated as a per se QBU under section 989
- Whether different rules should apply to partnerships under section 987 and 989 depending on the relatedness of the partners
- How an entity approach should apply with respect to a partnership with a different functional currency than its partners
- Whether section 987 should apply to CFCs and partnerships with only foreign partners
- If section 987 did not apply to CFCs or partnerships with only foreign partners, how excess inside asset basis arising from currency gain or loss should be addressed and prevented from importation into the U.S. without taxation
- If section 987 continues to apply to CFC and/or partnerships with only foreign partners, what modifications to the existing rules are needed

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