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Accounting for income taxes considerations of the issuance of the section 987 final regulations

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In December 2024, the U.S. Department of the Treasury released final regulations (the 2024 Final Regulations) and proposed additional regulations (the 2024 Proposed Regulations) under section 987[1] to determine taxable income or loss and foreign currency gain or loss with respect to a section 987 qualified business unit (QBU). A QBU is defined as a separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records. Common QBUs are divisions or branches, including those operating in different countries. The 2024 Final Regulations generally apply to tax years beginning after December 31, 2024. Therefore, in 2025, most taxpayers will be required to transition to the foreign exchange exposure pool methodology (the FEEP method) for calculating taxable income from a section 987 QBU. The FEEP method is used to determine taxable income or loss and the amount of gain or loss of the QBU that is due to changes in exchange rates. It does this by looking at the value of the QBU's assets and liabilities and how they are affected by currency fluctuations over the year. Taxpayers should assess the changes and recognize certain income taxes effects in the period that includes the issuance of the 2024 Final Regulations and the 2024 Proposed Regulations.

Background

Section 987 applies when an eligible QBU has a functional currency other than the U.S. dollar and that is different than the functional currency of its regarded owner (a section 987 QBU).

Overall

The 2024 Final Regulations provide rules for determining the taxable income or loss of an owner of a section 987 QBU. The regulations provide guidance for determining taxable income in the section 987 QBU’s functional currency including rules for translating each item into the functional currency of the owner of the section 987 QBU. As part of this guidance, the regulations provide a framework for translating the tax basis of assets and liabilities to be used for matters such as determining deductions for the recovery of basis of assets (for instance, amortization and depreciation) and determining gain or loss upon recovery or settlement of assets and liabilities. (for instance, through a sale). Under that framework, the recovery of tax basis of certain assets and liabilities is translated at historic exchange rates and has the practical effect of denominating the tax basis in the owner’s functional currency.

In addition, 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 the net value of the section 987 QBU attributable to certain assets and liabilities that are economically exposed to fluctuations in foreign currency. Section 987 gain or loss of an owner is generally recognized (subject to the deferral and loss suspension rules) when a section 987 QBU makes a remittance to its owner.

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the Code) or the applicable regulations promulgated pursuant to the Code (the regulations).

The 2024 Final Regulations include the current rate election (CRE), which modifies the FEEP method by translating all items on the section 987 QBU's tax basis balance sheet at the year-end spot rate, eliminating the need to track prior exchange rates for historic items, and subjecting the owner to the loss suspension rules whereby a company is unable to immediately claim a deduction for a section 987 loss. The 2024 Final Regulations also include an annual recognition election (ARE), which requires the recognition of unrecognized section 987 gains or losses 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.

Taxpayers should be aware of the entities in scope of the 2024 Final Regulations when assessing the tax effects of implementing the regulations. For example, the 2024 Final Regulations generally do not apply to partnerships, but provide that taxpayers must apply sections 987 and 989(a) to partnerships and eligible QBUs owned by partnerships using a reasonable method, subject to consistency requirements among related parties. Regardless of the specific method, certain provisions of the 2024 Final Regulations, including the suspension of section 987 losses, apply to these entities.

Transition rules

Applicability dates

The 2024 Final Regulations generally apply to taxable yeas beginning after December 31, 2024; however, the regulations apply retrospectively to a QBU that was terminated on or after November 9, 2023 or if a taxpayer elects to early adopt the 2024 Final Regulations for a taxable year ending after November 9, 2023.

Tax basis of assets and liabilities

In general, the tax basis of assets and liabilities in the owner's functional currency is measured using the spot rate applicable to the day before the transition date. However, there are exceptions to this rule. For example, (i) if an entity's eligible pretransition method with respect to a QBU is the earnings-only method, it would determine the tax basis of certain assets and liabilities using the same exchange rates that it would have used to translate the tax basis into the owner's functional currency if it had remitted such assets or liabilities to the owner on the day before the transition date and (ii) if an entity previously applied the fresh start transition method, it would determine the tax basis of certain assets and liabilities using the same historic exchange rates that were previously used.

Net accumulated unrecognized section 987 gain or loss

An owner of a section 987 QBU computes a pretransition gain or loss as of the day before the transition date, generally as of December 31, 2024 for calendar year taxpayers,[2] either using its existing section 987 method (if eligible) or under the simplified FEEP method.

To use its existing section 987 method, the owner must have applied an eligible pretransition method on a return filed before November 9, 2023. Taxpayers that were not on an eligible pretransition method must compute a pretransition gain or loss under the simplified FEEP method as if a CRE was made, which condenses the ten-step calculation under the regular FEEP method into two steps and limits application to tax years beginning on or after September 7, 2006.

Pretransition gains are treated as net accumulated unrecognized section 987 gains of the section 987 QBU. Conversely, except as noted below, a pretransition loss is treated as suspended section 987 loss of the owner that would generally be available to offset a recognized section 987 gain of the same source and character (loss-to-the-extent-of-gain rule) in a future year. However, if a CRE, but not an ARE, is in effect for the transition year, a pretransition loss is treated as a net accumulated

[2] In the case of a terminating QBU, the 2024 Final Regulations apply immediately before its termination. 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.

unrecognized section 987 loss (in other words, the loss is not suspended until a future remittance). Alternatively, taxpayers can make an election to amortize its net pretransition gain or loss over ten years beginning on the transition date.

Accounting for income taxes considerations upon issuance

Accounting for changes in tax laws

New regulations generally represent changes in currently enacted law.[3] ASC 740, *Income Taxes*, requires the tax effect of changes in tax laws and rates to be recognized in the period that includes the enactment date of the changes. The entire effect of changes in tax laws on current and deferred tax balances is recognized in income tax expense (benefit) from continuing operations, even if the deferred tax balances relate to a prior year or prior interim period transaction that was reported within discontinued operations, in other comprehensive income, or directly in shareholders' equity. Therefore, it is expected that any tax effects arising from the issuance of the 2024 Final Regulations will be accounted for in the period that includes the December 2024 release (for instance, the December 31, 2024 financial statements for calendar year-end taxpayers) and allocated to income tax expense (benefit) from continuing operations.

The accounting for the income tax effects of the issuance of the 2024 Final Regulations should include consideration of the elections an entity expects to make, and may result in the following potential implications:

- To the extent a QBU was terminated on or after November 9, 2023 or a taxpayer elects to early adopt the 2024 Final Regulations, an adjustment to income taxes receivable (payable) for a prior annual period,
- To the extent the 2024 Final Regulations result in tax basis for an asset or liability that is different than the amount an entity used for recognizing deferred taxes prior to the issuance of the 2024 Final Regulations, an adjustment to deferred taxes related to those assets or liabilities,
- An adjustment to deferred taxes for a net accumulated unrecognized section 987 gain or loss, or
- An adjustment to deferred taxes for a cumulative suspended section 987 loss.

The amount of adjustment to deferred taxes noted above may depend, in part, on whether the entity was previously in scope and therefore expecting to adopt the 2016 final regulations for tax years beginning on or after January 1, 2025.

Net accumulated unrecognized section 987 gain or loss

Amounts that become taxable or deductible upon a remittance from a foreign entity,[4] even if that foreign entity is a branch or disregarded entity, are generally considered temporary differences associated with an investment in that entity. Accordingly, in addition to recording the appropriate local and U.S. current taxes related to a foreign branch's operating results, as well as local and U.S. deferred taxes related to a foreign branch's assets and liabilities, a U.S. owner will also generally have a U.S. temporary difference associated with the amount of net accumulated unrecognized section 987 gain or loss of the branch. This temporary difference is generally considered an outside basis difference associated with an investment in a foreign entity.

ASC 740-30 exceptions

ASC 740-30 provides certain exceptions to the recognition of deferred taxes related to investments in subsidiaries. First, a deferred tax asset is recognized for the excess of the tax basis over the financial statement carrying amount of an investment in a subsidiary only if it is apparent that the temporary

[3] See paragraph 5.046 of KPMG Handbook: *Accounting for Income Taxes* (July 2024).
[4] See the ASC Master Glossary definition of a *foreign entity* that includes a branch as a foreign entity.

difference will reverse in the foreseeable future.[5] ASC 740 does not define foreseeable future; however, it has generally been considered in practice to be within one year. However, if a deductible temporary difference will reverse through normal business operations (for instance, through the mere passage of time), even if it is beyond a one-year period, it generally will be considered to meet the apparent to reverse within the foreseeable future criteria. Additionally, there should be a relatively high level of assurance that the temporary difference will reverse in the foreseeable future (for instance, an entity has an existing committed plan to execute a transaction). Generally, it would not be appropriate to recognize such a deferred tax asset if there are uncertainties concerning the form of a transaction or the ability to obtain a deduction for the excess tax basis under the tax law.

Additionally, a deferred tax liability is not recognized for an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary when the indefinite reversal criterion is met.[6] An entity must have specific plans for reinvestment of undistributed earnings that demonstrate the taxation of the outside basis difference will be postponed indefinitely.

The ASC 740-30 exceptions generally do not apply to basis differences associated with a foreign branch or other pass-through entity (such as an entity that has made a check-the-box election or disregarded entities), because, in addition to being subject to local tax, the income of the foreign entity is included in the parent entity's taxable income without regard to distributions; in other words, the branch is not a subsidiary, as the term is used in ASC 740-30. However, we understand that there is diversity in practice with respect to certain temporary differences associated with a foreign branch or other pass-through entity. As a result, we believe it is also acceptable to apply the ASC 740-30 exceptions to an outside basis difference that arises as a result of a net accumulated unrecognized section 987 gain or loss.

Most taxpayers have already established an accounting policy for whether to apply the ASC 740-30 exceptions to a net accumulated unrecognized section 987 gain or loss, withholding taxes, or branch profit taxes. Therefore, taxpayers should determine if an existing policy choice has already been elected with respect to whether a net accumulated unrecognized section 987 gain or loss is subject to the ASC 740-30 exceptions.

Recognizing deferred taxes

We anticipate some entities will have an adjustment to deferred taxes for the net accumulated unrecognized section 987 gain or loss. For example, entities that were not using an eligible pretransition method may have to determine a net accumulated unrecognized section 987 gain or loss based on the use of the simplified FEEP method. Additionally, entities that were anticipating adopting the 2016 final regulations using the fresh start method may have anticipated having its net accumulated unrecognized section 987 gain or loss balance eliminated and replaced with an amount based only on marked assets and liabilities.

As discussed above, whether a taxpayer has a pretransition gain or loss and the elections that are made impact when section 987 gains and losses are recognized. A taxpayer cannot assert that the indefinite reversal criterion is met or that a deductible temporary difference is not apparent to reverse in the foreseeable future if there is a plan to recognize pretransition gains and losses. For example, if a taxpayer has a net accumulated unrecognized section 987 gain or loss and expects to elect to amortize the amount, the related deferred tax asset or liability is recognized upon issuance of the 2024 Final Regulations, even if the entity has an accounting policy to apply the ASC 740-30 exceptions.

[5] ASC 740-30-25-9.
[6] ASC 740-30-25-17 and 25-18(a).

Cumulative suspended section 987 loss

As a result of transitioning to the 2024 Final Regulations, an entity may have a cumulative suspended section 987 loss. As of the date of adoption of the 2024 Final Regulations, a cumulative suspended section 987 loss arises as a result of pretransition losses and can only be utilized through offsetting future section 987 gains. Since a cumulative suspended section 987 loss represents an excess of deductions over income and its reversal is not related to the reduction of an asset or liability, we believe a cumulative suspended section 987 loss is an operating loss carryforward for which a deferred tax asset should be recognized regardless of an entity's ASC 740-30 policies, subject to valuation allowance considerations.

Section 987 matters within a CFC

Certain income of a foreign subsidiary is taxable to a U.S. parent when included in the earnings of a controlled foreign corporation (CFC), regardless of whether the income is actually distributed, which may impact the recognition of deferred taxes on such investments (for example, a foreign subsidiary that generates Subpart F income or global intangible low-taxed income (GILTI)). Entities typically have made a policy election to either provide deferred taxes related to GILTI or account for taxes on GILTI as a period cost when incurred, while deferred taxes are generally recognized for Subpart F temporary differences. We would generally expect that entities that elect to recognize deferred taxes related to GILTI and those that have any assets that produce Subpart F gross income will have some amount of adjustment to deferred taxes as a result the issuance of the 2024 Final Regulations. Conversely, if an entity recognizes GILTI as incurred and its CFCs only have assets that produce tested income, then it's possible no adjustment to deferred taxes may arise as a result of the issuance of the 2024 Final Regulations.

Valuation allowance observations

A valuation allowance is required for deferred tax assets if, based on available evidence, it is more likely than not that all or some portion of the asset will not be realized due to the inability to generate sufficient taxable income in the period or of the character necessary to realize the benefit of the deferred tax asset.

Many entities that utilize branch structures are in what is commonly referred to as a *high-tax* or *excess credit* situation. These entities generally generate more foreign tax credits than is necessary to offset U.S. federal income tax from the branches and incur no U.S. federal current taxes on the operations of branches. These entities often use a *with-and-without approach* to evaluate the recoverability of deferred tax assets of a branch basket character and often conclude they can only recognize deferred tax assets of a branch basket character to the extent of existing taxable temporary differences of a branch basket character. These entities may discover that any adjustments to deferred taxes as a result of the issuance of the 2024 Final Regulations are offset by a similar or identical adjustment to the valuation allowance.

Additionally, to the extent that a deferred tax asset is recognized for a net accumulated unrecognized section 987 loss that will become a suspended section 987 loss upon a remittance or for an existing cumulative suspended section 987 loss, this may reflect a long-term trend in the direction of exchange rates between a QBU's functional currency and its owner's functional currency. Cumulative currency losses over an extended period of time may be a significant piece of negative evidence about an entity's ability to generate section 987 gains that may be difficult to overcome. Future remittances resulting in the taxation of existing unrecognized section 987 gains are not considered as a source of income except to the extent a deferred tax liability has been recognized. Events that are dependent on future market conditions, such as changes in exchange rates, are generally not anticipated when assessing the need for a valuation allowance.

Changes in estimates

Recognizing income taxes in interim and annual periods for changes in tax laws requires an entity to analyze a significant amount of data and make judgments about the elections the entity expects to make. Determining the income tax effects is more challenging when income tax laws and regulations are new or the interpretations of them are evolving. As a result, the information and analysis necessary to narrow the range of possible outcomes to the same level of precision as routine transactions may not be available through reasonable effort. Given the timing of the issuance of the 2024 Final Regulations, it is possible that some entities will not be able to fully assess the effects of the regulations in the period that includes the December 2024 issuance. As such, subsequent adjustments to the amounts initially recognized may occur that will require analysis to determine if they represent changes in estimates or corrections of errors. An entity will need to evaluate whether a future change results from new information or information that existed and was reasonably knowable at the time the financial statements were prepared. Determining whether information was *reasonably knowable* at the time the financial statements were prepared can be highly judgmental. We believe information is *reasonably knowable* if it can be identified by making a reasonable effort.

2024 Proposed Regulations

The 2024 Proposed Regulations include elections to simplify the translation of certain ordinary course business transfers involving inventory, services, rents, or royalties between a section 987 QBU and its owner. The 2024 Proposed Regulations would apply to tax years beginning after the date they are published as final regulations in the Federal Register. However, taxpayers can rely on the 2024 Proposed Regulations in its entirety for tax years in which the 2024 Final Regulations apply, subject to consistency requirements within its consolidated group and section 987 electing group. Taxpayers may separately rely on portions of the regulations proposed on December 8, 2016 (the 2016 Proposed Regulations) that were not withdrawn or finalized for tax years in which the 2024 Final Regulations apply, subject to the same consistency requirement within its consolidated group and section 987 electing group.

Taxpayers should decide whether they will voluntarily early adopt the 2024 Proposed Regulations or separately apply portions of the 2016 Proposed Regulations. There is a presumption that beneficial tax positions will be claimed even if they are not claimed (or expected to be claimed) in the original filing of a tax return. Accordingly, to the extent these proposed regulations would be beneficial and meet the recognition and measurement guidance around uncertainty in ASC 740, then we would expect the voluntary early adoption to be reflected in financial statements.[7]

Conclusion

In summary, taxpayers should assess the changes resulting from the 2024 Final Regulations and the 2024 Proposed Regulations, such as which provisions will apply and what elections are expected to be made, and recognize the income taxes effects in the period that includes the issuance of the 2024 Final Regulations.

Related content

For additional analysis and observations on the final and proposed regulations under section 987, including implementation of the FEEP method, refer to the KPMG Report, *Determination under section 987 of taxable income or loss and foreign currency gain or loss with respect to a qualified business unit (QBU)*. For additional information on the accounting for income taxes considerations, refer to sections 3, 7, and 10 of the KPMG Handbook: *Accounting for income taxes*.

[7] See paragraph 3.116a of KPMG Handbook: *Accounting for Income Taxes* (July 2024).

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