

US: Additional delay of Section 987 foreign currency regulations has immediate significance for taxpayers, including CFCs

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Executive summary

On 13 June 2018, the United States (US) Treasury Department (the Treasury) and the US Internal Revenue Service (the IRS) announced ([Notice 2018-57](#)) that they intend to amend the final regulations under Section 987 (T.D. 9794, the Final Section 987 Regulations),¹ as well as certain related provisions of the temporary regulations under that section (T.D. 9795, the Temporary Section 987 Regulations), to further delay the applicability date of the Final Section 987 Regulations by one additional year.²

With the enactment of US tax reform, the additional delay creates immediate US federal income tax considerations for taxpayers, including controlled foreign corporations (CFCs).

Detailed discussion

Background

On 7 December 2016, the Treasury and the IRS released final (T.D. 9794), temporary (T.D. 9795), and proposed regulations (REG-128276-12) under Section 987. The final regulations address how certain branch operations (or qualified business units (QBUs)) that use a functional currency different

than that of their tax owner (Section 987 QBUs) compute taxable income or loss (or earnings and profits (E&P), as applicable). The Final Section 987 Regulations also provide rules to determine the timing, amount, character and source of any Section 987 gain or loss arising from a QBU. The Temporary Section 987 Regulations amend the definition of a QBU, provide rules addressing the deferral of Section 987 gain or loss in connection with certain QBU terminations, transactions involving partnerships, use of certain translation conventions, combinations, and separations of Section 987 QBUs and other related elections and special rules for Section 987 QBUs.³

On 2 October 2017, Notice 2017-57 announced amendments to delay the application of the Final Section 987 Regulations and certain related provisions of the Temporary Section 987 Regulations by one year.⁴

Notice 2018-57

Notice 2018-57 announces intended amendments to further delay the application of the Final Section 987 Regulations and certain related provisions of the Temporary Section 987 Regulations by one additional year. Consequently, the Final Section 987 Regulations now apply to tax years beginning on or after *three years* after the first date of the first tax year following 7 December 2016 (i.e., 1 January 2020, for in-scope, calendar-year taxpayers). Certain related temporary regulations (scheduled to expire on 6 December 2019) will no longer apply as temporary regulations but will remain in proposed form, unless a taxpayer elects to early adopt the regulations before 6 December 2019. No changes were made to the temporary regulations, which operate to defer the recognition of certain Section 987 gains and losses and certain Section 988 losses.⁵

The Treasury and the IRS also reiterated the intent to consider changes to the final regulations to permit taxpayers to elect to apply alternative rules for transitioning to the Final Section 987 Regulations and alternative rules for determining Section 987 gain or loss, but Notice 2018-57 does not provide any details of such alternative rules.

For purposes of Section 987, taxpayers may rely on the provisions of Notice 2018-57 before amendments to the Final Section 987 Regulations and the related Temporary Section 987 Regulations are issued.

Implications

The amended applicability date of the final regulations, subject to further amendments, gives taxpayers additional time to create and implement the complex systems and processes necessary to transition to and comply with the Final Section 987 Regulations. Notwithstanding the deferral of the application of the final regulations and certain corresponding provisions by another year, the enactment of new rules as part of US tax reform has immediate US federal income tax significance for US owners and CFC owners of Section 987 QBUs.

Overall Section 987 considerations

Notably, the postponement of the applicability date of the Final Section 987 Regulations does not change the requirement that in-scope taxpayers transition to the Final Section 987 Regulations using the fresh start transition method, which, for most taxpayers, may result in the elimination of any unrecognized Section 987 gain or loss under the taxpayer's current Section 987 methodology. Significantly, under the current transition rules, unrecognized Section 987 gain or loss attributable to nonmonetary items of Section 987 QBUs would be permanently disallowed for US federal income tax purposes.⁶

Therefore, taxpayers should identify their Section 987 QBUs, review QBU items, quantify the amount of any unrecognized Section 987 gain or loss under their current Section 987 methodology and consider the consequences of the current transition method, attribution rules and Section 987 gain and loss deferral rules. In addition, taxpayers should consider the treatment of Section 988 transactions of their Section 987 QBUs that are denominated in the owner's functional currency.

While the application of the Final Section 987 Regulations was delayed, Notice 2018-57 specifically indicates that such amendments do not affect the applicability date of other temporary and proposed regulations, including certain provisions that became effective on 6 January 2017 (or 7 December 2016, in certain cases) and apply more broadly to include taxpayers that are owners of Section 987 QBUs and are not within the scope of the Final Section 987 Regulations. These temporary and proposed regulations may defer recognition of Section 987 losses on outbound transfers, gains and losses on certain other terminations and related-party transfers, and may defer recognition of a borrower's foreign currency loss on related-party debt.

US tax reform impact on US Owners of Section 987 QBUs

Before transitioning to the Final 987 Regulations, US owners of Section 987 QBUs must use a reasonable method to comply with Section 987. For US partners of foreign partnerships, in particular, the delayed application of amendments to the definition of a QBU under Treas. Reg. Section 1.989(a)-1(b)(2) means that all partnerships, including partnerships wholly owned by related parties, continue to qualify as QBUs of each of their partners.

Considering that Section 987 determinations directly affect the taxable income of US owners, taxpayers should assess how their current Section 987 methodology interacts with taxable income determinations under new US tax reform provisions, including the so-called BEAT provisions of Section 59A, new interest limitation rules of Section 163(j), and the new Section 904(d) Foreign Branch Income basket rules. That is, US owners of Section 987 QBUs should evaluate whether to early adopt the Final Section 987 Regulations and whether to make any of the applicable elections provided in the final and temporary regulations. Owners that are not within the scope of the Final Section 987 Regulations also should assess whether to make any of the applicable elections, including the annual deemed termination election, in light of the increased relevance of Section 987 determinations as a result of US tax reform.

US tax reform impact on CFC Owners of Section 987 QBUs

Similarly, CFC owners of Section 987 QBUs must use a reasonable method to comply with Section 987 before transitioning to the Final Section 987 Regulations. For CFC owners, Section 987 determinations potentially affect their E&P. Thus, whether any E&P adjustments were required for Section 987 gain or loss realized in prior years is relevant to computing the one-time transition tax under Section 965(a).

Section 987 determinations and the impact on E&P also are relevant in determining the tested income or loss of CFC owners for purposes of Section 951A (the GILTI provisions). While CFC owners may not be required to adjust E&P for Section 987 gain or loss on the basis of immateriality, the GILTI provisions do not appear to provide a materiality

threshold in computing tested income or tested loss of a CFC. Thus, CFC owners should calculate Section 987 gain or loss amounts on an annual basis.

Moreover, under the Final Section 987 Regulations, in computing its annual subpart F income, a CFC's recognized Section 987 gains and losses are included in the foreign currency sub-category of foreign personal holding company income to the extent attributable to assets that generate subpart F income. For purposes of applying the GILTI provisions, a CFC's tested income is computed without regard to its subpart F income.⁷ Consequently, CFC owners should consider the interaction of the subpart F income rules and the GILTI provisions and whether to early adopt the Final Section 987 Regulations and make any of the applicable elections provided in the final and temporary regulations. Owners that are not within the scope of the Final Section 987 Regulations also should consider whether to make any of the applicable elections, including whether to make the annual deemed termination election.

Income tax accounting considerations

Notice 2018-57 (like Notice 2017-57) sets forth an administrative pronouncement, on which taxpayers can rely, providing a revised applicability date of the Section 987 regulations. There is also an election to apply the regulations early. As such, calendar-year taxpayers not electing to early adopt the regulations before the revised applicability date should consider whether existing deferred tax assets and liabilities will reverse before the revised applicability date of 1 January 2020, when measuring deferred tax assets and liabilities affected by the Section 987 regulations. A change in the applicability date is similar to a change in judgment given that Notice 2018-57 provides that the revised Section 987 regulations will allow taxpayers to elect to early adopt the original applicability date or use the revised applicability date. To the extent a change in judgment results in the subsequent recognition, derecognition, or changes in measurement of a deferred tax position that was previously recognized in a prior annual period, it should be considered a discrete event recognized in earnings in the period (interim as well as annual) in which the change occurs.

Endnotes

1. The Final Section 987 Regulations prescribe an entirely different approach to computing taxable income or loss and Section 987 gain or loss of a Section 987 QBU than has been used by most taxpayers for the past 30 years and impose substantial recordkeeping and compliance requirements.
2. Notice 2018-57 announces that the Treasury and the IRS intend to amend the Final Section 987 Regulations, corresponding provisions under Treas. Reg. Sections 1.861-9T, 1.985-5, 1.988-1, 1.988-4, and 1.989(a)-1(b) and (d), and certain temporary regulations under 1.987-1T through 1.987-4T (other than 1.987-1T(g)(2)(i)(B) and (g)(3)(i)(H) concerning the annual deemed termination election), 1.987-6T, 1.987-7T, and 1.988-1T (defined in Notice 2018-57 as the related temporary regulations) to provide that those regulations will apply to tax years beginning on or after three years after the first date of the first tax year following 7 December 2016.
3. For additional discussion, see EY Global Tax Alert, [*Final and temporary US foreign currency regulations change determination of branch taxable income and recognition of Section 987 gain or loss and defer Section 988 losses on certain related-party loans*](#), dated 13 December 2016.
4. See EY Global Tax Alert, [*US Treasury intends to delay application of final regulations under Section 987 by one year*](#), dated 4 October 2017.
5. See Treas. Reg. Section 1.987-12T(j) and 1.988-2T(j), respectively.
6. Note that future depreciation and amortization on existing historic assets is determined using a historic rate (i.e., the average or spot rate in effect for the year of acquisition). This will affect the future taxable income of the 987 QBU and may, in part, "offset" this effect.
7. See Section 951A(c)(2).

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