

US IRS finalizes certain temporary foreign currency regulations addressing recognition and deferral of Section 987 gain or loss

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Executive summary

In [T.D. 9857](#) effective May 13, 2019, the United States (US) Treasury and the Internal Revenue Service (IRS) finalized with certain clarifications Treas. Reg. Sections 1.987-2T and -4T (related to combinations and separations of qualified business units (QBUs) subject to Internal Revenue Code¹ Section 987) and Treas. Reg. Section 1.987-12T (addressing recognition and deferral of Section 987 gain and loss upon certain QBU terminations and certain other transactions involving partnerships). In addition, Treasury and the IRS withdrew Treas. Reg. Section 1.987-7T (regarding the allocation of assets and liabilities of certain partnerships for purposes of Section 987). No changes were made to the applicability dates of the final Section 987 regulations (T.D. 9794) or certain other temporary (T.D. 9795) and proposed (REG-128276-12) Section 987 regulations. Those regulations were previously delayed by Notice 2018-57 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). Treasury and the IRS continue to study other provisions of the temporary regulations under Section 987 that were not specifically addressed by T.D. 9857.

Detailed discussion

Background and explanation of revisions

On 7 December 2016, 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 provide guidance to corporate and individual taxpayers on determining taxable income with respect to QBUs whose functional currency differs from their owner (each an "IRC Section 987 QBU"), as well as the timing, amount, character and source of any Section 987 gain or loss arising from a QBU. The temporary regulations provided rules on combining and separating QBUs (Treas. Reg. Sections 1.987-2T and 1.987-4T), rules providing a liquidation value percentage methodology for allocating assets and liabilities of Section 987 aggregate partnerships (Treas. Reg. Section 1.987-7T), and rules requiring the deferral of foreign currency gain or loss under Section 987 with respect to certain transactions defined as deferral events or outbound loss events (Treas. Reg. Section 1.987-12T).

In Notice 2017-57, issued 16 October 2017, Treasury and the IRS announced that future guidance would defer the applicability dates of certain provisions of the temporary regulations and 2016 final regulations by one year.² On 25 June 2018, in Notice 2018-57, Treasury and the IRS announced amendments to further delay the applicability of the 2016 final regulations and certain provisions of the temporary regulations by one additional year. Consequently, the 2016 final regulations and certain provisions of the temporary regulations 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).³

Executive Order 13789 (the Executive Order), issued on 21 April 2017, instructed the Secretary of the Treasury to review all significant tax regulations issued on or after 1 January 2016 and try to alleviate the burdens of those regulations. On 16 October 2017, the Secretary published a final report (82 FR 48013) indicating that the Treasury and the IRS intended to modify the 2016 final regulations to reduce their burden and compliance challenge.

Treasury and the IRS received numerous comments in response to the Executive Order and Notice 2017-38 (Implementation of Executive Order 13789) recommending the withdrawal or a delayed applicability date of Treas. Reg. Sections 1.987-2T, 1.987-4T, and 1.987-12T because of

their complexity and the significant compliance burden on taxpayers. After considering the comments Treasury and the IRS decided to finalize those temporary regulations as Treas. Reg. Section 1.987-2(c)(9), 1.987-4(c)(2) and -4(f), and 1.987-12, respectively, to prevent the selective recognition of Section 987 losses and deferral of Section 987 gains.

After considering comments on Treas. Reg. Section 1.987-7T, Treasury and the IRS decided to withdraw Treas. Reg. Section 1.987-7T and make conforming changes to an example in Treas. Reg. Section 1.987-12. Treasury and the IRS will allow taxpayers to use any reasonable method for determining a partner's share of assets and liabilities in the books and records of an eligible QBU held indirectly through a partnership until new regulations are proposed and finalized. Thus, taxpayers may rely on Subchapter K principles or an approach similar to the liquidation value percentage method under Treas. Reg. Section 1.987-7T. To use the liquidation value percentage method, however, taxpayers would have to make corresponding adjustments to the determination of net unrecognized Section 987 gain or loss.

Applicability dates

Unless a taxpayer elects under Treas. Reg. Section 1.987-11(b) to apply the regulations early, the combination and separation rules of Treas. Reg. Sections 1.987-2(c)(9), 1.987-4(c)(2) and 1.987-4(f) apply to tax years beginning on or after the day that is three years after the first day of the first tax year following 7 December 2016 (i.e., 1 January 2020, for in-scope, calendar-year taxpayers).

The deferral and outbound loss event rules of Treas. Reg. Section 1.987-12 retain the applicability dates of *former* Treas. Reg. Section 1.987-12T. Accordingly, Treas. Reg. Section 1.987-12 generally applies to any deferral or outbound loss event occurring on or after 6 January 2017, including any deferral or outbound loss event that occurs due to an entity classification election made under Treas. Reg. Section 301.7701-3 on or after that date. Treas. Reg. Section 1.987-12, however, applies to a deferral or outbound loss event that occurs on or after 7 December 2016, if the deferral or outbound loss event was undertaken with the principal purposes of recognizing Section 987 loss. The same rule applies to any deferral or outbound loss event resulting from an entity classification election made under Treas. Reg. Section 301.7701-3 on or after 22 December 2016, that was effective before 7 December 2016, and undertaken with the principal purpose of recognizing Section 987 loss.

Implications

The finalization of these temporary regulations makes permanent the combination and separation rules of *former* Treas. Reg. Sections 1.987-2T and -4T and the deferral event and outbound loss event rules of *former* Treas. Reg. Section 1.987-12T, which were otherwise scheduled to expire on 6 December 2019. While their finalization is unsurprising, there are some important implications for taxpayers.

Importance for taxable income and Section 951A determinations

As discussed in prior Alerts, all owners of Section 987 QBUs should be currently calculating Section 987 gain or loss on an annual basis. For US owners of Section 987 QBUs, Section 987 determinations can directly affect taxable income, and thus, may be relevant for other US tax reform provisions, including the so-called BEAT (base erosion anti-abuse tax) provisions of Section 59A, the foreign-derived intangible income deduction in Section 250(a), the interest limitation rules of Section 163(j), and the Section 904(d) foreign branch income basket rules. Similarly, for controlled foreign corporation (CFC) owners of Section 987 QBUs, Section 987 determinations can directly affect the tested income or tested loss of a CFC under Section 951A (the GILTI (global intangible low-taxed income) provisions). In making such determinations, all owners of Section 987 QBUs should be considering the deferral and outbound loss

event rules of Treas. Reg. Section 1.987-12, which currently apply. Taxpayers should also continue to monitor the status of the other final Section 987 regulations, which continue to be delayed until 1 January 2020, for in-scope, calendar-year taxpayers under the provisions of Notice 2018-57. In addition, as first indicated in Notice 2017-57, we may see amendments to the final regulations, as “Proposed modification of regulations under [IRC Section] 987 on income and currency gain or loss with respect to a [IRC Section] 987 qualified business unit” is on Treasury’s 2018-2019 Priority Guidance Plan. As of now, however, the final regulations (and the required foreign exchange exposure pool method) are generally effective 1 January 2020, for calendar-year taxpayers.

Importance for taxpayers that have engaged in deferral or outbound-loss-event transactions

Treas. Reg. Section 1.987-12(i) currently retains the fresh start coordination rules from *former* Treas. Reg. Section 1.987-12T(i). Consequently, all owners of Section 987 QBUs that have engaged in deferral or outbound-loss-event transactions should consider the potential consequences of the fresh start transition method for any deferred Section 987(3) gain or loss and related stock basis adjustments. Under Notice 2018-57, fresh start transition has been delayed until 1 January 2020, for in-scope, calendar years unless a taxpayer elected to early apply the final Section 987 regulations under Treas. Reg. Section 1.987-11(b).

Endnotes

1. All “Section” references are to the Internal Revenue Code (IRC) of 1986, and the regulations promulgated thereunder.
2. See EY Global Tax Alert, [US Treasury intends to delay application of final regulations under Section 987 by one year](#), dated 4 October 2017.
3. See EY Global Tax Alert, [US: Additional delay of Section 987 foreign currency regulations has immediate significance for taxpayers, including CFCs](#), dated 19 June 2018.

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EYG no. 002400-19Gbl

1508-1600216 NY
ED None

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