DEPARTMENT OF THE TREASURY

Internal Revenue Service

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[TD 9795]

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Recognition and Deferral of Section 987 Gain or Loss

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations under section 987 of the Internal Revenue Code (Code) relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a qualified business unit (QBU) in connection with certain QBU terminations and certain other transactions involving partnerships. This document also contains temporary regulations under section 987 providing: an annual deemed termination election for a section 987 QBU; an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; rules regarding the treatment of section 988 transactions of a section 987 QBU; rules regarding QBUs with the U.S. dollar as their functional currency; rules regarding combinations and separations of section 987 QBUs; rules regarding the translation of income used to pay creditable foreign income taxes; and rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987. Finally, this document contains temporary regulations under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Federal Register**. In addition, in the Rules and Regulations section of this issue of the **Federal Register**, final regulations are being issued under section 987 to provide general guidance under section 987 regarding the determination of the taxable income or loss of a taxpayer with respect to a QBU.

DATES: *Effective date.* These regulations are effective on December 7, 2016.

Applicability date. For dates of applicability, see §§ 1.987–1T(h), 1.987–2T(e), 1.987–3T(f), 1.987–4T(h), 1.987–6T(d), 1.987–7T(d), 1.987–8T(g), 1.987–12T(j), 1.988–1T(j), and 1.988–2T(j).

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SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–2265. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, the accuracy of the estimated burden and suggestions for reducing this burden, and where to submit comments on the collection of information, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register**.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains temporary regulations under section 987 of the Code relating to the recognition and deferral of foreign currency gain or loss under section 987 with respect to a QBU in connection with certain QBU terminations and certain other transactions involving partnerships. This document also contains temporary regulations under section 987 providing (i) an annual deemed termination election for a section 987 QBU; (ii) an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss with respect to a section 987 QBU at the yearly average exchange rate; (iii) rules regarding the treatment of section 988 transactions of a section 987 QBU; (iv) rules regarding QBUs with the U.S. dollar as their functional currency; (v) rules regarding combinations and separations of section 987 QBUs; (vi) rules regarding the translation of income used to pay creditable foreign income taxes; and (vii) rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987. Finally, this document contains temporary regulations under section 988 requiring the deferral of certain section 988 loss that arises with respect to related-party loans.

Section 987 generally provides that, when a taxpayer owns one or more QBUs with a functional currency other than the U.S. dollar and such functional currency is different than that of the taxpayer, the taxable income or loss of the taxpayer with respect to each such QBU is determined by computing the taxable income or loss of each QBU separately in its functional currency and translating such income or loss at the appropriate exchange rate. Section 987 further requires the taxpayer to make ''proper adjustments'' (as prescribed by the Secretary of the Treasury (the Secretary)) for transfers of property between QBUs having different functional currencies, including by treating post-1986 remittances from each such QBU as made on a pro rata basis out of post-1986 accumulated earnings, by treating section 987 gain or loss as ordinary income or loss, and by sourcing such gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.

Section 989(c) directs the Secretary to ''prescribe such regulations as may be necessary or appropriate to carry out the purposes of [subpart J], including regulations . . . limiting the recognition of foreign currency loss on certain remittances from qualified business units . . . [and] providing for the appropriate treatment of related party transactions (including transactions between qualified business units of the same taxpayer). . . .''

On September 6, 2006, the Treasury Department and the IRS issued proposed regulations under section 987 (REG–208270–86, 71 FR 52876) (the 2006 proposed regulations). The Treasury Department and the IRS received many written comments in response to the 2006 proposed regulations and, after consideration of those comments, are issuing final regulations (TD 9794) under section 987 (the final regulations) that are being published contemporaneously with these temporary regulations. These temporary regulations also reflect the consideration of comments received on the 2006 proposed regulations, as well as other considerations described in this preamble.

Explanation of Provisions

1. Deferral of Section 987 Gain or Loss on Certain Terminations and Other Transactions Involving Partnerships

A. Background

Under the final regulations, the owner of a section 987 QBU that terminates includes in income all of the net unrecognized section 987 gain or loss with respect to the section 987 QBU in the year it terminates. See §§ 1.987–5(c)(3) and 1.987–8(e). Section 1.987–8(b) and (c) describe the circumstances in which a section 987 QBU terminates, which include the transfer (or deemed transfer) of substantially all of the assets of the section 987 QBU and when the section 987 QBU's owner ceases to exist (except in connection with certain liquidations or reorganizations described in section 381(a)). Under these rules, a termination can result solely from a transfer of a section 987 QBU between related parties or, when a QBU is owned by an entity that is disregarded as an entity separate from its owner for Federal tax purposes (DE), from the deemed transfer that occurs when an election is made to treat the DE as a corporation for Federal tax purposes, notwithstanding that the QBU's assets continue to be used in the same trade or business.

The preamble to the 2006 proposed regulations requested comments regarding whether inbound liquidations under section 332 and inbound asset reorganizations under section 368(a) should result in terminations of section 987 QBUs. The preamble also requested comments on the interaction of the rules of § 1.1502–13 regarding intercompany transactions with the 2006 proposed regulations, including whether section 987 gain or loss resulting from the transfer of assets and liabilities of a section 987 QBU between members of the same consolidated group in a section 351 transaction should be deferred under § 1.1502–13. Many comments recommended that such a section 351 exchange should not trigger the recognition of section 987 gain or loss.

Because a termination can result in the deemed remittance of all the assets of a section 987 QBU in circumstances in which the assets continue to be used by a related person in the conduct of the same trade or business that formerly was conducted by the section 987 QBU, terminations can facilitate the selective recognition of section 987 losses. Section 989(c)(2) provides the Treasury Department and the IRS with authority to ''limit[] the recognition of foreign currency loss on certain remittances from qualified business units.'' The Treasury Department and the IRS have determined that terminations of section 987 QBUs generally should not be permitted to achieve the selective recognition of losses when the assets and liabilities of the section 987 QBU are transferred to a related person and remain subject to section 987 in the hands of the transferee, as in the case, for example, of a section 351 transfer of a section 987 QBU within a consolidated group. Similar policy considerations arise when the transfer of a partnership interest to a related person results in deemed transfers that cause the recognition of section 987 loss with respect to a section 987 QBU owned through the partnership, notwithstanding that the trade or business of the section 987 QBU continues without interruption and remains subject to section 987. In order to address these policy concerns, as described in greater detail in Part 1.C of this Explanation of Provisions, the temporary regulations defer section 987 losses resulting from certain termination events and partnership transactions in which the assets and liabilities of the section 987 QBU remain within a single controlled group (defined as all persons with the relationships to each other described in sections 267(b) or 707(b)) and remain subject to section 987.

The Treasury Department and the IRS also acknowledge, however, that part of the rationale for deferring section 987 losses—that is, the continuity of ownership of the section 987 QBU within a single controlled group—applies equally to section 987 gains that otherwise would be triggered when taxpayers transfer a section 987 QBU within a single controlled group. Thus, consistent with the recommendations of comments on the 2006 proposed regulations, the temporary regulations generally apply to defer the recognition of section 987 gains as well as losses when the transferee is subject to section 987 with respect to the assets of the section 987 QBU. The Treasury Department and the IRS have determined, however, that gain should not be deferred to the extent the assets of a section 987 QBU are transferred by a U.S. person to a related foreign person. Since recognition of the deferred gain generally would occur only as a result of remittances to the foreign owner, the IRS could face administrative difficulty in attempting to ensure that such deferred gain is appropriately recognized and not indefinitely deferred. Treating gains differently than losses in the context of transfers to related foreign persons generally is consistent with the policies underlying sections 267 and 367. In particular, this rule is consistent with the policy of recognizing foreign currency gains and not losses with respect to property transferred outbound in a nonrecognition transaction. See section 367(a)(3)(B)(iii).

In addition, the Treasury Department and the IRS have determined that selective recognition of losses should not be permitted in the context of certain outbound transfers even when the assets do not remain subject to section 987 in the hands of the transferee (because, for example, the transferee has the same functional currency as the QBU). Accordingly, consistent with the principles of sections 267 and 367(a), the temporary regulations also provide special rules to prevent the selective recognition of section 987 losses in certain other transactions involving outbound transfers.

B. Scope of Application of § 1.987–12T

Section 1.987–12T provides for the deferral of certain net unrecognized section 987 gain or loss that otherwise would be recognized in connection with specified events under § 1.987–5, which governs the recognition of section 987 gain or loss by the owner of a section 987 QBU to which the final regulations apply. In addition, because the policy concerns that motivate § 1.987–12T exist regardless of whether section 987 gain or loss is computed pursuant to the final regulations or some other reasonable method, § 1.987–12T applies to any foreign currency gain or loss realized under section 987(3), including foreign currency gain or loss realized under section 987 with respect to a QBU to which the final regulations generally are not applicable. In order to achieve this, the temporary regulations specify that references in § 1.987–12T to section 987 gain or loss refer to any foreign currency gain or loss realized under section 987(3) and that references to a section 987 QBU refer to any eligible QBU (as defined in § 1.987–1(b)(3)(i), but without regard to § 1.987–1(b)(3)(ii)) that is subject to section 987. Additionally, the temporary regulations specify that references in § 1.987–12T to the recognition of section 987 gain or loss under § 1.987–5 encompass any determination and recognition of gain or loss under section 987(3) that would occur but for § 1.987–12T. Accordingly, the temporary regulations require an owner of a QBU that is not subject to § 1.987–5 to adapt the rules set forth in § 1.987–12T to recognize section 987 gains or losses consistent with the principles of § 1.987–12T.

The policy concerns regarding selective realization of section 987 losses do not apply, however, with respect to a section 987 QBU that has made the annual deemed termination election described in Part 2 of this Explanation of Provisions, because all section 987 gain and loss is recognized annually under that election. Accordingly, § 1.987–12T is not applicable to section 987 gain or loss of a section 987 QBU with respect to which the annual deemed termination election is in effect.

Finally, in order to avoid any compliance burden associated with applying § 1.987–12T in circumstances involving relatively small amounts of section 987 gain or loss, § 1.987–12T includes a de minimis rule. That rule provides that § 1.987–12T does not apply to a section 987 QBU if the net unrecognized section 987 gain or loss of the section 987 QBU that, as a result of § 1.987–12T, would not be recognized under § 1.987–5 does not exceed $5 million.

Section 1.987–12T defers the recognition of section 987 gains and losses in connection with two types of specified events, which are referred to as ''deferral events'' and ''outbound loss events.'' Parts 1.C and 1.D of this Explanation of Provisions describe the rules governing deferral events and outbound loss events, respectively.

C. Deferral Events

As described in greater detail below, the temporary regulations provide that, notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which a deferral event occurs (a deferral QBU) must defer section 987 gain or loss that otherwise would be taken into account under § 1.987–5 in connection with the deferral event to the extent determined under § 1.987–12T(b)(3) and (c). Such deferred gain or loss is taken into account based on subsequent events in accordance with § 1.987–12T(c).

i. Deferral Events

The temporary regulations provide that a deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy two conditions. Under the first condition, the transaction or series of transactions must be described in one of two categories. The first category, which is set forth in § 1.987–12T(b)(2)(ii)(A), is any termination of a section 987 QBU other than (i) a termination described in § 1.987–8(b)(3) (that is, a termination that results from the owner of the section 987 QBU ceasing to be a controlled foreign corporation (as defined in section 957(a)) (CFC) after certain related-party transactions); (ii) a termination described in § 1.987–8(c) (that is, a termination that results from a liquidation or asset reorganization described in section 381(a) involving an inbound or outbound transfer, a transfer by a CFC to a related non-CFC foreign corporation, or a transfer to a transferee that has the same functional currency as the section 987 QBU); [1] or (iii) a termination described solely in § 1.987–8(b)(1) (that is, a termination that results solely from the cessation of the trade or business of the section 987 QBU). Thus, the first category generally involves terminations that occur as a result of a transfer of substantially all the assets of a section 987 QBU other than a transfer as part of a transaction described in section 381(a) in which the owner ceases to exist. (A termination that results from an outbound section 381(a) transaction, however, may be an outbound loss event.)

The second category, which is described in § 1.987–12T(b)(ii)(B), encompasses certain partnership transactions that result in a net deemed transfer from a section 987 QBU to its owner as a result of which section 987 gain or loss otherwise would be recognized under § 1.987–5. The second category refers to two types of transactions involving partnerships.

First, the second category includes a disposition of part of an interest in a DE or partnership. Under § 1.987–2(c)(5), a transfer of part of an interest in a DE or section 987 aggregate partnership results in deemed transfers to the owner of a section 987 QBU held through that DE or partnership that may result in a remittance, but that generally do not cause a termination. For an illustration of the application of § 1.987–12T to a deferral event resulting from the conversion of a disregarded entity into a section 987 aggregate partnership, see § 1.987–12T(h), *Example 4.*

The second type of transaction included in the second category is a contribution of assets by a related person to a partnership or DE through which a section 987 QBU is held, provided that the contributed assets are not included on the books and records of an eligible QBU and the contribution causes a net transfer from a section 987 QBU owned through the partnership or DE. The rules of § 1.987–2 must be applied to determine whether the contribution would cause a net transfer from any section 987 QBUs held through a partnership. For example, if two partners (Partner A and Partner B) each own a 50% interest in an existing section 987 aggregate partnership with a single section 987 QBU, and Partner A contributes cash that is included on the books of the section 987 QBU after the contribution and Partner B contributes an equal amount of non-portfolio stock, the contributions would not cause either Partner A nor Partner B to have a net transfer from the section 987 QBU under § 1.987–2 and there would be no section 987 gain or loss to defer. As a result of the broad scope of application for § 1.987–12T specified in § 1.987–12T(a)(2), the second category includes transactions involving partnerships that are not section 987 aggregate partnerships even though QBUs that are held through such partnerships generally are not subject to the final regulations. Accordingly, § 1.987–12T applies to a disposition of a partnership interest or a contribution to a partnership if it otherwise would result in recognition of gain or loss under a taxpayer's reasonable method of applying section 987.

The second condition described in § 1.987–12T(b)(2) is that, immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor QBU. For this purpose, a successor QBU with respect to a section 987 QBU (original QBU) generally means a section 987 QBU on whose books and records assets of the original QBU are reflected immediately after the deferral event, provided that, immediately after the deferral event, the section 987 QBU is owned by a member of the controlled group that includes the person that owned the original QBU immediately before the deferral event. This relatedness requirement would not be met, for example, if the person that owned the original QBU ceased to exist in connection with the deferral event.

However, if the owner of the original QBU is a U.S. person, then a successor QBU does not include a section 987 QBU owned by a foreign person, except in the case of a deferral event that is solely described in the second category of transactions involving partnership and DE interests. This limitation on the definition of a successor QBU in the context of outbound transfers serves two purposes. First, consistent with the general policy of recognizing foreign currency gains upon an outbound transfer, the limitation ensures that section 987 gain is recognized to the extent section 987 QBU assets are transferred outbound in connection with a termination. Second, the

[1] The transfer of a section 987 QBU as part of a liquidation or asset reorganization described in section 381(a) in which the transferor and transferee have the same tax status is not a termination under § 1.987–8(b) and (c) and, therefore, cannot constitute a deferral event under the first category.

limitation coordinates the deferral event rules with the outbound loss event rules described in Part 1.D of this Explanation of Provisions, which contain different rules for the recognition of section 987 loss attributable to assets of a section 987 QBU that are transferred outbound in connection with a termination of the section 987 QBU.

ii. Recognition of Section 987 Gain or Loss Under § 1.987–5 in the Taxable Year of a Deferral Event

The temporary regulations provide that, in the taxable year of a deferral event, the owner of the deferral QBU generally recognizes section 987 gain or loss as determined under § 1.987–5, except that, solely for purposes of applying § 1.987–5, all assets and liabilities of the deferral QBU that, immediately after the deferral event, are properly reflected on the balance sheet of a successor QBU are treated as not having been transferred and therefore as remaining on the balance sheet of the deferral QBU, notwithstanding the deferral event. The effect of these rules is that, in the taxable year of a deferral event, only assets and liabilities of the deferral QBU that are not reflected on the books and records of a successor QBU immediately after the deferral event are taken into account in determining the amount of a remittance from the deferral QBU. Section 987 gain or loss that, as a result of these rules, is not recognized under § 1.987–5 in the taxable year of the deferral event is referred to as deferred section 987 gain or loss. As discussed in Part 1.D of this Explanation of Provisions, if the deferral event also constitutes an outbound loss event, the amount of loss recognized by the owner may be further limited under the rules applicable to outbound loss events.

iii. Recognition of Deferred Section 987 Gain or Loss in the Taxable Year of a Deferral Event and in Subsequent Taxable Years

The temporary regulations provide rules for determining when a deferral QBU owner recognizes deferred section 987 gain or loss. For this purpose, a deferral QBU owner means, with respect to a deferral QBU, the owner of the deferral QBU immediately before the deferral event with respect to the deferral QBU or the owner's qualified successor. The temporary regulations define a qualified successor with respect to a corporation (transferor corporation) as another corporation (acquiring corporation) that acquires the assets of the transferor corporation in a transaction described in section 381(a), but only if (A) the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or (B) the acquiring corporation is a CFC and the transferor corporation was a CFC. A qualified successor of a corporation includes a qualified successor of a qualified successor of the corporation.

As described in the remainder of this Part 1.C.iii, the temporary regulations provide that deferred section 987 gain or loss is recognized upon subsequent remittances from a successor QBU, or upon a deemed remittance that occurs when a successor QBU ceases to be owned by a member of the deferral QBU owner's controlled group, subject to an exception that applies when a successor QBU terminates in an outbound transfer. In general, these rules depend on the continued existence of a deferral QBU owner (which includes a qualified successor) and a successor QBU and preserve the location of the deferred section 987 gain or loss as gain or loss of the deferral QBU owner.

a. Subsequent Remittances

A deferral QBU owner generally recognizes deferred section 987 gain or loss in the taxable year of a remittance from a successor QBU to the owner of the successor QBU (successor QBU owner). The amount of deferred section 987 gain or loss that a deferral QBU owner recognizes upon a remittance is the outstanding deferred section 987 gain or loss (that is, the deferred section 987 gain or loss not previously recognized) multiplied by the remittance proportion of the successor QBU owner with respect to the successor QBU for the taxable year as determined under § 1.987–5(b) and, to the extent relevant, § 1.987–12T. For an illustration of this rule, see § 1.987–12T(h), *Example 5*.

In certain cases, there may be multiple successor QBUs with respect to a single deferral QBU. For instance, there may be multiple successor QBUs if the owner of a section 987 aggregate partnership interest transfers part of its interest or if a successor QBU separates into two or more separated QBUs under § 1.987–2T(c)(9)(ii). To ensure that a deferral QBU owner recognizes the appropriate amount of deferred section 987 gain or loss in connection with a remittance in such cases, the temporary regulations provide that multiple successor QBUs of the same deferral QBU are treated as a single successor QBU for purposes of determining the amount of deferred section 987 gain or loss that is recognized.

For example, if the owner (Corp A) of a section 987 aggregate partnership interest transfers part of its interest to another member of Corp A's consolidated group (Corp B), the transfer would give rise to a deferral event with respect to the section 987 QBU (QBU A) that Corp A indirectly owns through the partnership. QBU A would be considered a deferral QBU, and Corp A would be considered a deferral QBU owner. In addition, QBU A would be considered a successor QBU with respect to itself, and the section 987 QBU (QBU B) that Corp B owns indirectly through the partnership interest it acquired also would be considered a successor QBU with respect to QBU A. In determining the amount of deferred section 987 gain or loss recognized upon subsequent remittances from successor QBUs, the two successor QBUs are treated as a single successor QBU, such that their remittance proportion is determined under § 1.987–5 on a combined basis, taking into account the assets and remittances of both successor QBUs.

b. Deemed Remittance When a Successor QBU Ceases To Be Owned by a Member of the Deferral QBU Owner's Controlled Group

Solely for purposes of determining a deferral QBU owner's recognition of any outstanding deferred section 987 gain or loss, a successor QBU owner is treated as having a remittance proportion of 1 in a taxable year in which its successor QBU ceases to be owned by a member of a controlled group that includes the deferral QBU owner, including as a result of the deferral QBU owner ceasing to exist without having a qualified successor. Accordingly, a deferral QBU owner would recognize all outstanding deferred section 987 gain or loss upon a successor QBU ceasing to be owned by a member of the deferral QBU owner's controlled group if there is only one successor QBU, but would recognize only a proportional amount if there are multiple successor QBUs, one or more of which remain in the deferral QBU owner's controlled group.

c. Recognition of Deferred Section 987 Loss in Certain Outbound Successor QBU Terminations

Notwithstanding that deferred section 987 gain or loss generally is recognized upon remittances from a successor QBU, § 1.987–12T(c)(3) provides that, if assets of a successor QBU are transferred (or deemed transferred) in an exchange that would constitute an outbound loss event if the successor QBU had a net accumulated section 987 loss at the time of the exchange, the deferral QBU owner recognizes any outstanding deferred section 987 loss on a similar basis as it would if it originally had transferred the deferral QBU in an outbound loss event. Any outstanding deferred section 987 loss with respect to the deferral QBU that, as a result of this rule, is not recognized is recognized by the deferral QBU owner in the first taxable year in which the deferral QBU owner (including any qualified successor) and the acquirer of the assets of the successor QBU (or any qualified successor) cease to be members of the same controlled group. Section 1.987–12T(c)(4) ensures that the policy concerns that motivate the treatment of outbound loss events under the temporary regulations apply in comparable circumstances involving successor QBUs. See Part 1.D of this Explanation of Provisions for an explanation of outbound loss events.

d. Special Rules Regarding Successor QBUs

The temporary regulations include three special rules regarding successor QBUs that are relevant to the recognition of deferred section 987 gain or loss. First, if a section 987 QBU is a successor QBU with respect to a deferral QBU that is a successor QBU with respect to another deferral QBU, the first-mentioned section 987 QBU is considered a successor QBU with respect to the second-mentioned deferral QBU. For example, if QBU A is a successor QBU with respect to QBU B, and QBU B is a successor QBU with respect to QBU C, then QBU A is a successor QBU with respect to QBU C.

Second, if a successor QBU with respect to a deferral QBU separates into two or more separated QBUs (as defined in § 1.987–2T(c)(9)(iii)), each separated QBU is considered a successor QBU with respect to the deferral QBU.

Third, if a successor QBU with respect to a deferral QBU combines with another section 987 QBU of the same owner, resulting in a combined QBU (as defined in § 1.987–2T(c)(9)(i)), the combined QBU is considered a successor QBU with respect to the deferral QBU.

iv. Source and Character of Deferred Section 987 Gain and Loss

The temporary regulations provide that the source and character of deferred section 987 gain or loss is determined under § 1.987–6 as if such gain or loss had been recognized with respect to the deferral QBU under § 1.987–5 on the date of the deferral event that gave rise to the deferred section 987 gain or loss. Thus, the source and character of deferred section 987 gain or loss is determined under § 1.987–6 without regard to the timing rules of § 1.987–12T.

D. Outbound Loss Events

Section 1.987–12T(d) of the temporary regulations contains rules that defer section 987 loss to the extent assets of a section 987 QBU are transferred outbound to a related foreign person in connection with an ''outbound loss event.'' Specifically, the temporary regulations provide that, notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which an outbound loss event occurs (outbound loss QBU) includes in taxable income in the year of the outbound loss event section 987 loss with respect to that section 987 QBU only to the extent provided in § 1.987–12T(d)(3). Sections 1.987–12T(d)(4) and (5) provide rules for the subsequent recognition of losses that are deferred under § 1.987–12T(d) that differ from the remittance-based rules that generally apply following deferral events.

Like the definition of deferral event, an outbound loss event includes two categories of transactions with respect to a section 987 QBU with net unrecognized section 987 loss. First, an outbound loss event includes any termination of the section 987 QBU in connection with a transfer of assets of the section 987 QBU by a U.S. person to a foreign person that was a member of the same controlled group as the U.S. transferor immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (related foreign person). The second category of outbound loss events includes any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership or DE through which the U.S. person owns the section 987 QBU to a related foreign person that has the same functional currency as the section 987 QBU. The second category also includes a contribution of assets by such a related foreign person to the partnership or DE if the contribution has the effect of reducing the U.S. person's interest in the section 987 QBU (and therefore causes a deemed transfer of assets and liabilities to the U.S. person from the section 987 QBU) and the contributed assets are not included on the books and records of an eligible QBU of the partnership or DE. The second category would be implicated, for example, if a U.S. person transferred part of the interest in a DE through which it owned a section 987 QBU to a foreign corporation that had the same functional currency as the section 987 QBU in an outbound section 351 transaction.

Under these rules, the owner of the outbound loss QBU recognizes section 987 loss in the taxable year of the outbound loss event as determined under § 1.987–5 and the deferral event rules of § 1.987–12T(b) and (c), except that, solely for purposes of applying § 1.987–5, certain assets and liabilities of the outbound loss QBU are treated as not having been transferred and therefore as remaining on the balance sheet of the section 987 QBU, notwithstanding the outbound loss event. In the first category of outbound loss event (involving outbound asset transfers resulting in terminations), assets and liabilities that, immediately after the outbound loss event, are properly reflected on the books and records of the related foreign person or a section 987 QBU of the related foreign person are treated as not having been transferred. In the second category of outbound loss event (involving certain partnership and DE transactions), assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the eligible QBU from which the assets and liabilities of the outbound loss QBU are allocated, and not on the books and records of a section 987 QBU, are treated as not having been transferred. The difference between the amount that otherwise would have been recognized and the amount actually recognized under this rule is referred to as outbound section 987 loss.

Although an outbound loss event in the second category also would constitute a deferral event, the rules governing deferral events only defer section 987 loss of a deferral QBU to the extent assets and liabilities are reflected on the books and records of a successor QBU immediately after the deferral event. Assets and liabilities of a deferral QBU that are reflected on the books and records of an eligible QBU of a partnership and allocated to a partner that has the same functional currency as the eligible QBU, as would occur in an outbound loss event, are not reflected on the books and records of a successor QBU and so would not cause section 987 loss to be deferred under the deferral event rules. Thus, there is no overlap in terms of the effect of the outbound loss event rules and the deferral event rules.

If an outbound loss event results from the transfer of assets of the outbound loss QBU in a nonrecognition transaction, the basis of the stock that is received in the transaction is increased by an amount equal to the outbound section 987 loss. In effect, this rule converts a section 987 loss into an unrealized stock loss, which may be recognized upon a recognition event with respect to the stock. This treatment is similar to the treatment under section 367(a) of foreign currency losses with respect to foreign-currency denominated property that is transferred outbound in a nonrecognition event to a foreign corporation that has as its functional currency the currency in which the property is denominated. Outbound section 987 loss attributable to an outbound loss event that does not occur in connection with a nonrecognition transaction is recognized by the owner of the outbound loss QBU in the first taxable year in which the owner (or any qualified successor) and the related foreign person that participated in the outbound loss event (or any qualified successor) cease to be members of the same controlled group. In many circumstances this treatment will provide similar results as converting section 987 loss into stock basis as in the case of outbound loss events that result from a nonrecognition transaction.

The temporary regulations provide that, if loss is recognized on the sale or exchange of stock within two years of an outbound loss event that gave rise to an adjustment to the basis of the stock, then, to the extent of the outbound section 987 loss, the source and character of the loss recognized on the sale or exchange will be determined under § 1.987–6 as if such loss were section 987 loss recognized pursuant to § 1.987–5 without regard to § 1.987–12T on the date of the outbound loss event.

E. Anti-Abuse Rule

The temporary regulations provide an anti-abuse rule to address transactions structured to avoid the deferral rules in § 1.987–12T. This rule provides that no section 987 loss is recognized under § 1.987–5 in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of § 1.987–12T. This rule would apply, for example, if, with a principal purpose of recognizing a deferred section 987 loss, a taxpayer engaged in a transaction that caused a deferral QBU owner to cease to exist without a qualified successor or caused a successor QBU to cease to exist, such that deferred section 987 loss otherwise would be recognized under § 1.987–12T(c).

F. Coordination With Fresh Start Transition Method

The temporary regulations require adjustments to coordinate the application of § 1.987–12T with the fresh start transition method described in § 1.987–10(b) for transitioning to the final regulations. If a deferral QBU owner is required under § 1.987–10(a) to apply the fresh start transition method with respect to the deferral QBU on the transition date, or if a deferral QBU owner would have been so required if it had owned the deferral QBU on the transition date, the outstanding deferred section 987 gain or loss of the deferral QBU owner with respect to the deferral QBU must be adjusted on the transition date to equal the amount of outstanding deferred section 987 gain or loss that the deferral QBU owner would have had with respect to the deferral QBU on the transition date if, immediately before the deferral event, the deferral QBU had transitioned to the final regulations pursuant to the fresh start transition method. Additionally, if the owner of an outbound loss QBU is required under § 1.987–10(a) to apply the fresh start transition method with respect to the outbound loss QBU on the transition date, or if the owner would have been so required if it had owned the outbound loss QBU on the transition date, the basis of any stock that was subject to a basis adjustment under § 1.987–12T as a result of the outbound loss event must be adjusted to equal the basis that such stock would have had on the transition date if, immediately prior to the outbound loss event, the outbound loss QBU had transitioned to the final regulations pursuant to the fresh start transition method. Outbound section 987 loss that is not reflected in stock basis but that will be recognized when the owner and the related foreign person that participated in the outbound loss event cease to be members of the same controlled group must be adjusted in a similar manner. These adjustments to coordinate the application of § 1.987–12T with the fresh start transition method must be made even if the deferral QBU owner or the owner of the outbound loss QBU continues to own the deferral QBU or the outbound loss QBU on the transition date, as in the case of a deferral event or outbound loss event resulting from a transfer of part of an interest in a section 987 aggregate partnership that does not result in the termination of the deferral QBU or outbound loss QBU.

G. Effective Date

The temporary regulations under § 1.987–12T generally apply to any deferral event or outbound loss event that occurs on or after *January 6, 2017.* However, if the deferral event or outbound loss event is undertaken with a principal purpose of recognizing section 987 loss, the 30 day delayed effective date does not apply and § 1.987–12T is effective immediately on December 7, 2016.

2. Annual Deemed Termination Election

A comment on the 2006 proposed regulations recommended that taxpayers be permitted to make a one-time election under § 1.987–5 to deem a section 987 QBU as having terminated at the end of each year, thereby requiring the owner to recognize all section 987 gains or losses with respect to the QBU on an annual basis. The comment suggested that such an election would allow taxpayers to reduce the complexity and administrative cost of complying with section 987 because taxpayers would not be required to track transactions between an owner and its section 987 QBU or unrecognized section 987 gains and losses carried over from previous years.

The Treasury Department and the IRS have determined that an annual deemed termination election would not obviate the need to track transactions between an owner and its section 987 QBU, since the net transfer would remain relevant to the annual calculation of section 987 gain or loss. Nonetheless, the Treasury Department and the IRS agree that an annual deemed termination election could enhance administrability of the final regulations by reducing the recordkeeping requirements necessary to apply the final regulations. Additionally, when an annual deemed termination election is in effect, taxpayers could not strategically time remittances in order to selectively recognize section 987 losses but not section 987 gains. Eliminating this planning opportunity would obviate the need for the deferral provisions of § 1.987–12T. Furthermore, as discussed in Part 3 of this Explanation of Provisions, an annual deemed termination election would address a policy concern with permitting the hybrid approach to section 987 suggested by comments on the 2006 proposed regulations.

Based on the foregoing considerations, § 1.987–8T(d) provides an election for a taxpayer to deem its section 987 QBUs to terminate on the last day of each taxable year for which the election is in effect. Because the considerations supporting an annual deemed termination election generally are relevant regardless of whether a taxpayer is subject to the final regulations, the election under § 1.987–8T(d) is available to any taxpayer without regard to the applicability of the final regulations to that taxpayer or any of its section 987 QBUs. A section 987 QBU to which this election applies is treated as having made a remittance of all of its gross assets to its owner immediately before the section 987 QBU terminates on the last day of each taxable year, resulting in the recognition of any net unrecognized section 987 gain or loss of the section 987 QBU. See §§ 1.987–5(c)(3) and 1.987–8(e). The owner is then treated as having transferred all of the assets and liabilities of the terminated section 987 QBU to a new section 987 QBU on the first day of the following taxable year.

As noted in Part 1 of this Explanation of Provisions, the temporary regulations provide that the deferral provisions of § 1.987–12T do not apply with respect to section 987 QBUs for which the annual deemed termination election is in effect. Consequently, a taxpayer that finds the annual deemed termination election preferable to § 1.987–12T based on ease of compliance or other reasons may make the annual deemed termination election. Moreover, as discussed in Part 3 of this Explanation of Provisions, a taxpayer that makes the annual deemed termination election with respect to a section 987 QBU may reduce the compliance burden associated with computing taxable income or loss under the final regulations by electing to translate taxable income or loss of the section 987 QBU into the owner's functional currency at the yearly average exchange rate without any adjustments.

The Treasury Department and the IRS have determined that special consistency and effective date rules are needed for the annual deemed termination election to prevent taxpayers from using the election to selectively recognize section 987 losses without recognizing section 987 gains. Unless the annual deemed termination election is required to be made with respect to all section QBUs owned by related persons at the time of the election, taxpayers could choose to make the election only with respect to section 987 QBUs that have net unrecognized section 987 losses at the time of the election. Accordingly, § 1.987–1T(g)(2)(i)(B)(*1*) provides that the annual deemed termination election generally applies to all section 987 QBUs owned by an electing taxpayer, as well as to all section 987 QBUs owned by any person that has a relationship to the taxpayer described in section 267(b) or section 707(b) (substituting ''and the profits interest'' for ''or the profits interest'' in section 707(b)(1)(A) and substituting ''and profits interests'' for ''or profits interests'' in section 707(b)(1)(B)) on the last day of the first taxable year for which the election applies to the taxpayer (a related person).

A taxpayer that is subject to the final regulations and that must transition to the final regulations under the fresh start transition method of § 1.987–10(b) (fresh start taxpayer) may make the annual deemed termination election only if the first taxable year for which the election would apply is either (i) the first taxable year beginning on or after the transition date (as defined in § 1.987–11(c)) with respect to the taxpayer or (ii) a subsequent taxable year in which the ''taxpayer's controlled group aggregate section 987 loss'' (if any) does not exceed $5 million. For this purpose, a ''taxpayer's controlled group aggregate section 987 loss'' means the aggregate net amount of section 987 gain or loss that would be recognized pursuant to the election under § 1.987–8T(d) by the taxpayer and all related persons in the first taxable year of each person for which the election would apply.

Taxpayers that used a method based on a reasonable application of the 2006 proposed regulations prior to the transition date, and which therefore are not subject to the fresh start transition method pursuant to § 1.987–10(c), and taxpayers for which the final regulations are not applicable, must follow the election rules for fresh start taxpayers if any related party is a fresh start taxpayer. If no related party is a fresh start taxpayer, the annual deemed termination election may be made only if the first taxable year for which the election would apply is either (i) the first taxable year beginning on or after December 7, 2016, in which the election is relevant in determining section 987 taxable income or loss or section 987 gain or loss or (ii) a subsequent taxable year in which the ''taxpayer's controlled group aggregate section 987 loss'' (if any) does not exceed $5 million.

If a taxpayer makes the annual deemed termination election, the election will apply to the first taxable year of a related person that ends with or within a taxable year of the taxpayer to which the taxpayer's election applies. Once made, the annual deemed termination election may not be revoked.

As provided in § 1.987–1T(g)(2)(i)(B)(*2*), the special consistency and effective date rules in § 1.987–1T(g)(2)(i)(B)(*1*) do not apply and a taxpayer may make a separate election under § 1.987–8T(d) with respect to any section 987 QBU owned by the taxpayer if the first taxable year for which the election would apply to the taxpayer with respect to the section 987 QBU is a taxable year in which the deemed termination results in the recognition of section 987 gain with respect to the section 987 QBU or the deemed termination results in the recognition of $1 million or less of section 987 loss with respect to the section 987 QBU.

3. Election To Translate All Items at the Yearly Average Exchange Rate

As discussed in the preamble to the final regulations, comments on the 2006 proposed regulations recommended a hybrid approach that would combine the methodology of the regulations proposed under section 987 in 1991 (INTL–965–86, 56 FR 48457) for computing a section 987 QBU's net income with the methodology of the 2006 proposed regulations for computing section 987 gain or loss. Under the proposed hybrid approach, section 987 gain or loss generally would be determined under the method of the 2006 proposed regulations, but taxable income or loss would be translated into the owner's functional currency at the yearly average exchange rate without any adjustments.

Although a hybrid approach would simplify the calculation of section 987 taxable income or loss, the preamble to the final regulations observes that the hybrid approach gives rise to offsetting effects in section 987 taxable income or loss and in the foreign exchange exposure pool (FEEP) that raise concerns similar to those addressed by Congress in enacting section 1092. In particular, under the hybrid approach, exchange rate effects with respect to historic assets would be reflected in section 987 taxable income or loss to the extent of any cost recovery deductions with respect to those assets, but equal and offsetting amounts would be reflected in the FEEP and would be recognized only upon remittances. Thus, offsetting effects arising from a single asset would be taken into account at different times. The Treasury Department and the IRS have determined that it would be inappropriate for regulations under section 987 to permit distortions to section 987 taxable income or loss that have the effect of causing potentially large offsetting amounts of loss or gain to be reflected in the FEEP with respect to the same asset, since the loss or gain in the FEEP would be recognized only upon voluntary remittances from the QBU.

Nonetheless, the Treasury Department and the IRS acknowledge the concerns expressed in comments regarding the complexity of the 2006 proposed regulations that underlie the recommendation to adopt the hybrid approach. Concerns about offsetting amounts recognized at different times under the hybrid approach would not arise for taxpayers that make the annual deemed termination election set forth in § 1.987–8T(d). A taxpayer that recognizes all section 987 gain or loss with respect to its section 987 QBUs annually would take into account in recognized section 987 gain or loss the exchange rate effects with respect to historic assets that are reflected in the FEEP in the same taxable year in which the offsetting effects are taken into account in section 987 taxable income or loss. Although the hybrid approach could result in differences in character of exchange gain or loss relative to the final regulations even for taxpayers that make the annual deemed termination election, the Treasury Department and the IRS have determined that the administrative convenience of allowing taxpayers to translate a section 987 QBU's taxable income at the yearly average exchange rate outweighs that consideration.

Accordingly, the temporary regulations provide that a taxpayer that is otherwise generally subject to the final regulations may elect to apply the hybrid approach with respect to a section 987 QBU that is subject to the annual deemed termination election. In particular, § 1.987–3T(d) provides that, notwithstanding the rules of § 1.987–3(c) for translating items determined under § 1.987–3(b) in a section 987 QBU's functional currency into the owner's functional currency, a taxpayer may elect to translate all items of income, gain, deduction, and loss of a section 987 QBU with respect to which the annual deemed termination election described in § 1.987–8T(d) is in effect into the owner's functional currency, if necessary, at the yearly average exchange rate for the taxable year. An owner of multiple section 987 QBUs may make the election described in § 1.987–3T(d) with respect to all of its section 987 QBUs or only certain designated section 987 QBUs.

4. Section 988 Transactions of a Section 987 QBU

A. Background Regarding the Treatment of Section 988 Transactions Under the Proposed Regulations

The 2006 proposed regulations reflected a two-pronged approach to the application of section 988 to transactions of a section 987 QBU, with different consequences generally depending on whether a transaction is denominated in (or determined by reference to) the owner's functional currency or a currency that is a nonfunctional currency with respect to both the owner and the section 987 QBU (third currency). As a general rule, § 1.987–3(e)(1) of the 2006 proposed regulations provided that section 988 applies to section 988 transactions attributable to a section 987 QBU and that the timing of any gain or loss is determined under the applicable provisions of the Code, but the 2006 proposed regulations did not clearly specify whether section 988 gain or loss would be determined with respect to the functional currency of the section 987 QBU or the owner's functional currency. Assets and liabilities giving rise to section 988 transactions were defined under proposed § 1.987–1(d) and (e) as historic items. Under § 1.987–3(e)(2) of the 2006 proposed regulations, transactions of a section 987 QBU described in section 988(c)(1)(B)(i) (relating to the acquisition of, or becoming an obligor under, a debt instrument), section 988(c)(1)(B)(ii) (relating to accrual of items of expense or gross income or receipts) or section 988(c)(1)(C) (relating to the disposition of nonfunctional currency) that are denominated in (or determined by reference to) the owner's functional currency, however, were not treated as section 988 transactions of the section 987 QBU, and no gain or loss was recognized under section 988 with respect to such transactions. Assets and liabilities giving rise to such transactions were required to be reflected on the balance sheet of the section 987 QBU in the owner's functional currency under § 1.987–2(d)(2) of the 2006 proposed regulations.

Additionally, § 1.987–3(d) of the 2006 proposed regulations provided that an item of income, gain, deduction, or loss of a section 987 QBU denominated in a currency other than the functional currency of the owner is translated at the spot rate on date the item is appropriately taken into account. Under § 1.987–3(c) of the 2006 proposed regulations, an item of income, gain, deduction, or loss of a section 987 QBU denominated in the owner's functional currency is not translated and is taken into account by the section 987 QBU in the owner's functional currency.

One comment indicated that the 2006 proposed regulations were unclear regarding the interaction of the rules for the treatment of section 988 transactions denominated in a third currency with the treatment of assets that give rise to section 988 transactions as historic assets. Upon the disposition of a historic asset, the 2006 proposed regulations required translation of the basis of the historic asset at the historic rate and the amount realized with respect to the asset at the yearly average exchange rate for the taxable year of the disposition or, if properly elected, the appropriate spot rate. Yet, § 1.987–3(f), *Example 10* of the 2006 proposed regulations illustrated the determination of section 988 gain or loss on a third-currency section 988 transaction in, and by reference to, the section 987 QBU's functional currency and translation of that amount into the owner's functional currency at the yearly average exchange rate. Under the approach of the example, historic asset basis is effectively translated at the yearly average exchange rate rather than the appropriate historic rate.

B. General Rules for Section 988 Transactions in the Temporary Regulations

In light of the comment regarding the uncertain application of section 988 to transactions of a section 987 QBU under the 2006 proposed regulations and further consideration of the appropriate rules, the temporary regulations clarify and elaborate upon the application of section 988 to transactions attributable to a section 987 QBU. In this regard, the Treasury Department and the IRS have determined that computing section 988 gain or loss by reference to the functional currency of the section 987 QBU, rather than the owner's functional currency, and translating that amount at the yearly average exchange rate would be inconsistent with the treatment of items that give rise to section 988 transactions as historic items. Such items were treated as historic items under the 2006 proposed regulations because they do not economically expose the owner to fluctuations in the section 987 QBU's functional currency.

Taking these considerations into account, the Treasury Department and the IRS have determined that it is appropriate to continue to treat assets and liabilities giving rise to section 988 transactions of a section 987 QBU as historic items under §§ 1.987–1(d) and (e) of the final regulations. Thus, for example, a note denominated in a nonfunctional currency that gives rise to a section 988 transaction when acquired is a historic asset. However, the temporary regulations generally provide that section 988 gain or loss arising from section 988 transactions of a section 987 QBU is determined by reference to the owner's functional currency, rather than the functional currency of the section 987 QBU. See § 1.987–3T(b)(4)(i). Accordingly, in determining section 988 gain or loss with respect to a section 988 transaction of a section 987 QBU, the amounts required under section 988 to be translated on the applicable booking date or payment date with respect to the section 988 transaction are translated from the currency in which the amounts are denominated (or by reference to which they are determined) into the owner's functional currency at the rate required under section 988 and the section 988 regulations, which provide for translation at the appropriate spot rate.

When a section 987 QBU recognizes gain or loss on the disposition of a historic asset that gives rise to a section 988 transaction, some or all of the total gain or loss that is realized on the disposition may be section 988 gain or loss that, under section 988, is ordinary income that is sourced by reference to the residence of the section 987 QBU. For example, on the disposition of a nonfunctional currency note, the total gain or loss realized may be comprised of section 988 gain or loss that reflects exchange rate changes and other gain or loss that reflects other factors, such as changes in prevailing interest rates or in the creditworthiness of the note issuer. The total gain or loss on the disposition of a historic asset that gives rise to a section 988 transaction is determined under the general rules of section 987 by reference to the functional currency of the section 987 QBU. Section 988 gain or loss on the note is determined under §§ 1.988–2(b)(5) and (8) and 1.987–3T(b)(4)(i) by comparing the section 987 QBU's acquisition price for the note in nonfunctional currency translated into the owner's functional currency at the spot rates on the date of acquisition and the date of disposition, respectively. See § 1.987–3T(e), *Example 11.* To provide for consistent translation rates for determining both the total gain or loss on such a historic asset and the portion of the total gain or loss that is section 988 gain or loss, § 1.987–3T(c)(2)(ii) specifies that the spot rate also must be used to translate the amount received with respect to a historic asset if the acquisition of the historic asset gave rise to a section 988 transaction. Additionally, consistent with the regulations under § 1.988–1(d) regarding the use of spot rate conventions for section 988 transactions, § 1.987–1T(c)(1)(ii)(B) specifies that the election in § 1.987–1(c)(1)(ii)(A) to use a spot rate convention generally does not apply for purposes of determining section 987 taxable income or loss with respect to a historic item (as defined in § 1.987–1(e)) if acquiring, accruing, or entering into such item gave rise to a section 988 transaction or a specified owner functional currency transaction (discussed in this Part B).

Because assets and liabilities that give rise to section 988 transactions generally are historic items that have a spot rate as the historic rate under § 1.987–1T(c)(3)(i)(E), such assets and liabilities are translated at historic rates and do not give rise to section 987 gain or loss. Thus, when the general rules for section 988 transactions of a section 987 QBU apply, the owner will take into account under subpart J foreign currency exposure with respect to a section 988 transaction of a section 987 QBU only to the extent of the owner's economic exposure to fluctuations of its functional currency relative to the currency in which the section 988 transaction is denominated.

Additionally, consistent with the 2006 proposed regulations, the temporary regulations confirm that certain transactions that are denominated in (or determined by reference to) the owner's functional currency are not subject to section 988. Specifically, § 1.987–3T(b)(4)(ii) provides that specified owner functional currency transactions, which are defined as transactions described in section 988(c)(1)(B)(i) or (ii) or section 988(c)(1)(C) (including the acquisition of nonfunctional currency described in § 1.988–1(a)(1)) that are denominated in (or determined by reference to) the owner's functional currency, other than certain transactions described in § 1.987–3T(b)(4)(iii)(A) that are subject to a mark-to-market regime (discussed in Part 4.C of this Explanation of Provisions), are not treated as section 988 transactions. Although the temporary regulations do not follow the 2006 proposed regulations in specifying that assets and liabilities that give rise to specified owner functional currency transactions must be reflected on the balance sheet of the section 987 QBU in the owner's functional currency, the temporary regulations treat items that give rise to specified owner functional currency transactions as historic items that generally have a spot rate as the historic rate under § 1.987–1T(c)(3)(i)(E) and provide under § 1.987–3T(b)(2)(ii) that the basis and amount realized of a historic asset that gives rise to a specified owner functional currency transactions are not translated if denominated in the owner's functional currency. Together, these rules have the same effect as the treatment of specified owner functional currency transactions under the 2006 proposed regulations.

C. Special Rules To Allow Greater Conformity With the Financial Accounting Treatment for Certain Section 988 Transactions

As discussed in the preamble to the final regulations, under the financial accounting standard described in Accounting Standards Codification, Foreign Currency Matters, section 830 (ASC 830), gains and losses from changes in exchange rates with respect to transactions that are denominated in a currency other than the entity's functional currency are referred to as ''transaction'' gains and losses. The category of foreign currency transactions that give rise to transaction gains and losses for financial accounting purposes overlaps considerably with the definition of a section 988 transaction for tax purposes, such that transaction gains and losses under financial accounting rules are conceptually similar to section 988 gains and losses. The financial accounting rules require the inclusion of transaction gains and losses in net income for the period in which the exchange rate changes occur. See ASC 830–20–35–1. Moreover, transaction gain or loss is always determined by reference to the functional currency of the entity that entered into the transaction. Thus, the financial accounting rules differ from the general tax rules applicable to section 988 transactions entered into by a section 987 QBU in two respects. First, the financial accounting rules require transaction gain or loss to be determined on a mark-to-market basis, whereas gain or loss from a section 988 transaction generally is not recognized until there is a realization event under general tax principles and the applicable provisions of the Code. Second, the financial accounting rules require transaction gain or loss to be determined by reference to the entity's functional currency, even when it differs from the reporting currency used in the consolidated financial statements and the transaction is denominated in the reporting currency.

As noted in the preamble to the final regulations, comments on the 2006 proposed regulations expressed a preference for greater consistency of the section 987 regulations with financial accounting rules. Taking these comments into account, the Treasury Department and the IRS have determined that providing treatment similar to the financial accounting treatment for certain section 988 transactions of section 987 QBUs will enhance administrability of the section 987 regulations with respect to such transactions and is consistent with the policies of sections 987 and 988.

Accordingly, as discussed in Part 1.C.i of this Explanation of Provisions, the temporary regulations permit a taxpayer to elect to determine section 987 gain or loss with respect to qualified short-term section 988 transactions (described in Part 1.C.i of this Explanation of Provisions) of a section 987 QBU under a foreign currency mark-to-market method of accounting. In addition, as discussed in Part 4.C.ii of this

Explanation of Provisions, the temporary regulations provide that section 988 gain or loss with respect to qualified short-term section 988 transactions that are accounted for under a mark-to-market method of accounting for Federal tax purposes (including the elective method described in Part 1.C.i of this Explanation of Provisions) is determined in, and by reference to, the functional currency of the section 987 QBU rather than the functional currency of its owner.

i. Election To Apply a Foreign Currency Mark-to-Market Method of Accounting for Certain Section 988 Transactions

The Treasury Department and the IRS have determined that allowing a taxpayer to mark to market foreign currency gain or loss with respect to qualified short-term section 988 transactions of a section 987 QBU will enhance administrability by aligning the timing for recognizing gain or loss with respect to such transactions with the financial accounting rules. Accordingly, a taxpayer may elect, on a QBU-by-QBU basis, under § 1.987–3T(b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting to qualified short-term section 988 transactions. Under this election, the timing of section 988 gain or loss is determined for applicable transactions under the principles of section 1256(a)(1). Thus, when the election applies, section 988 gain or loss with respect to a qualified short-term section 988 transaction is recognized on an annual basis, but other gain or loss with respect to any property underlying the transaction (*e.g.,* gain or loss on a debt instrument due to interest rate fluctuations) is determined under the otherwise applicable recognition provisions.

A qualified short-term section 988 transaction is defined in § 1.987–3T(b)(4)(iii)(B) as a section 988 transaction, including a transaction denominated in the owner's functional currency, that both (1) occurs in the ordinary course of the section 987 QBU's business and (2) has an original term of one year or less on the day it is entered into by the section 987 QBU. The holding of currency that is nonfunctional currency (within the meaning of section 988(c)(1)(C)(ii)) to the section 987 QBU in the ordinary course of a section 987 QBU's trade or business also is treated as a qualified short-term section 988 transaction.

ii. Special Rule Requiring Gain or Loss From Certain Section 988 Transactions That Are Subject to a Mark-to-Market Method of Accounting To Be Determined by Reference to the Functional Currency of the Section 987 QBU

The temporary regulations include a special rule for determining section 988 gain or loss with respect to qualified short-term section 988 transactions (as described in Part 4.C.i of this Explanation of Provisions) of a section 987 QBU that are accounted for under a mark-to-market method of accounting. Specifically, § 1.987–3T(b)(4)(iii)(A) provides that section 988 gain or loss with respect to qualified short-term section 988 transactions of a section 987 QBU, and certain related hedges, that are accounted for under a mark-to-market method of accounting under section 475, section 1256, or § 1.987–3T(b)(4)(iii)(C) (discussed in Part 4.C.i of this Explanation of Provisions) is determined in, and by reference to, the functional currency of the section 987 QBU rather than the owner's functional currency. Items that give rise to qualified short-term section 988 transactions for which section 988 gain or loss is determined under § 1.987–3T(b)(4)(iii)(A) by reference to the section 987 QBU's functional currency are treated as marked items under § 1.987–1T(d)(3), with the result that gain or loss attributable to such items is translated at the yearly average exchange rate and that such items give rise to net unrecognized section 987 gain or loss.

Under the rules for qualified short-term section 988 transactions accounted for under a mark-to-market method of accounting, a section 987 QBU owner will take into account the full amount of its economic foreign currency exposure arising from such transactions, but the effects of such exposure generally will be bifurcated into a component reflected in section 987 taxable income or loss and a component reflected in the FEEP pool and recognized upon a remittance. These components could offset each other if the currency in which the section 988 transaction is denominated and the owner's functional currency moved in opposite directions relative to the section 987 QBU's functional currency. Restricting this treatment to qualified short-term section 988 transactions accounted for under a mark-to-market method of accounting limits the potential for abusive planning. In particular, the restriction to transactions accounted for under a mark-to-market method of accounting prevents selective realization of section 988 losses that would be taken into account in section 987 taxable income or loss in situations in which an offsetting gain is reflected in the FEEP. Additionally, short-term, ordinary-course section 988 transactions are less likely than other section 988 transactions to give rise to substantial offsetting effects in section 987 taxable income or loss and in the FEEP.

5. Application of Section 987 to QBUs With the U.S. Dollar as a Functional Currency

Consistent with the opening clause of section 987, which indicates that section 987 applies to the determination of the taxable income of any taxpayer ''having 1 or more qualified business units with a functional currency other than the dollar,'' § 1.987–1T(b)(6)(i) sets forth a general rule that section 987 and the regulations thereunder do not apply with respect to an eligible QBU (determined without regard to the scope limitations of § 1.987–1(b)(3)(ii)) that has the U.S. dollar as its functional currency and that would be subject to section 987 if it had a functional currency other than the U.S. dollar (dollar QBU).

The Treasury Department and the IRS have determined, however, that it is appropriate for a CFC that is the owner of a dollar QBU to recognize foreign currency gain or loss with respect to transactions of the dollar QBU that would be section 988 transactions if entered into directly by the owner. Accordingly, pursuant to the authority granted in section 985(a), § 1.987–1T(b)(6)(ii)(A) provides that the CFC owner of a dollar QBU will be subject to section 988 with respect to any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU. For purposes of applying section 988 to such items, § 1.987–1T(b)(6)(ii)(A) provides that such items are treated as properly reflected on the books and records of the dollar QBU's owner. Thus, except as provided in the special rule described later in this Part 5 of this Explanation of Provisions for computing income that is effectively connected with the conduct of a trade or business within the United States (ECI), a CFC would determine section 988 gain or loss from transactions of a dollar QBU by reference to the CFC's functional currency. For example, for purposes of determining its earnings and profits, a CFC that has a euro functional currency and that is the owner of a dollar QBU with a U.S. dollar-denominated liability would apply section 988 with respect to that U.S. dollar-denominated liability, measuring section 988 gain or loss on the section 988 transaction arising from the liability by reference to the euro.

As a result of treating such items as properly reflected on the books and records of the CFC, instead of those of the dollar QBU, the CFC's section 988 gain or loss with respect to such items generally would be treated as foreign source income because section 988(a)(3) generally provides that the source of section 988 gain or loss is determined by reference to the residence of the taxpayer or QBU on whose books the asset, liability, or other item giving rise to the section 988 transaction is properly reflected. Section 1.988–4 then would apply to determine whether the section 988 gain or loss would be treated as ECI. Because a QBU with ECI must have the U.S. dollar as its functional currency (§ 1.985–1(b)(1)(v)), section 988 gain or loss measured by reference to the owner CFC's functional currency would not be ECI. However, the temporary regulations provide a special rule for certain section 988 transactions of a dollar QBU (including section 988 transactions denominated in the owner's functional currency) that arise from the conduct of a United States trade or business.

The special rule applies to a CFC owner of a dollar QBU that would have a section 988 transaction that would give rise to section 988 gain or loss that would be treated as ECI under § 1.988–4(c) if the item that would give rise to the section 988 transaction were treated as properly reflected on the books and records of the dollar QBU. Under § 1.987–1T(b)(6)(ii)(B), solely for purposes of determining the amount of section 988 gain or loss of the CFC that is ECI, any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU and, consequently, is determined by reference to the U.S. dollar.

The application of § 1.987–1T(b)(6)(ii) to a section 988 transaction that is denominated in a third currency (that is, neither the CFC's functional currency nor the U.S. dollar) could result in the same section 988 transaction generating ECI (determined by reference to the U.S. dollar) and generating subpart F income (determined by reference to the CFC owner's functional currency), subject to any limitation imposed by section 952(b). Under section 952(b), if the amount determined under § 1.987–1T(b)(6)(ii)(A) by reference to the owner's functional currency and the amount of ECI determined under § 1.987–1T(b)(6)(ii)(B) were both gains, only the excess, if any, of the gain determined by reference to the owner's functional currency over the ECI gain would be taken into account in determining subpart F income. If the amount determined under § 1.987–1T(b)(6)(ii)(A) by reference to the owner's functional currency and the amount of ECI determined under § 1.987–1T(b)(6)(ii)(B) were both losses, the loss determined by reference to the owner's functional currency would be taken into account in determining subpart F income only to the extent it exceeds the ECI loss.

The Treasury Department and the IRS recognize the potential administrative burden associated with applying the foregoing rules to a dollar QBU, which may give rise to a large number of section 988 transactions. Accordingly, § 1.987–1T(b)(6)(iii) provides an election for a CFC that directly or indirectly owns a dollar QBU to apply section 987 and the regulations thereunder in lieu of applying section 988 pursuant to § 1.987–1T(b)(6)(ii). The Treasury Department and the IRS have determined that, when this election applies, the source of foreign currency gain or loss that is determined under section 987 pursuant to the election should be consistent with the source that would have been determined under section 988 in the absence of the election. Accordingly, consistent with the source rule in section 988(a)(3), § 1.987–6T(b)(4) provides that the source of section 987 gain or loss determined with respect to a dollar QBU for which the owner has elected to apply section 987 is determined by reference to the residence of the CFC owner. Thus, such section 987 gain or loss will have a foreign source.

As is the case for dollar QBUs of CFCs that do not make the election under § 1.987–1T(b)(6)(iii) to apply section 987, CFCs that make the election and that have a dollar QBU that engages in a U.S. trade or business must apply a special rule to determine the amount of ECI that arises from transactions that would give rise to section 988 gain or loss if determined by reference to the dollar QBU's U.S. dollar functional currency. This special rule for determining the amount of ECI applies only to dollar QBUs that generate ECI because, under § 1.985–1(b)(1)(v), a QBU that produces income or loss that is, or is treated as, ECI must use the dollar as its functional currency. The special rule is needed for dollar QBUs that elect to be treated as section 987 QBUs because, under the general rules of § 1.987–3T(b)(4)(i) and (ii), which apply to all section 987 QBUs other than with respect to certain short-term transactions described in § 1.987–3T(b)(4)(iii)(B) that are accounted for under a mark-to-market method of accounting, section 988 gain or loss of a section 987 QBU with respect to transactions denominated in a third currency is determined in, and by reference to, the functional currency of the owner of the section 987 QBU, and section 988 gain or loss generally is not determined with respect to specified owner functional currency transactions described in Part 4.B of this Explanation of Provisions. Thus, in order to determine the appropriate amount of ECI from transactions of a dollar QBU for which an election to apply section 987 is in effect, § 1.987–1T(b)(6)(iii)(B) provides that, solely for purposes of determining the amount of section 988 gain or loss that is ECI, any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under § 1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating the item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar. For purposes of determining the amount of section 988 gain or loss for other purposes, including to determine the earnings and profits of the CFC, the rules in § 1.987–3T(b)(4)(i) and (ii) continue to apply. As is the case for a CFC that has not made the election to apply section 987 in lieu of section 988, a transaction to which the special rule applies could generate both ECI and subpart F income.

6. Combinations and Separations of QBUs

A. Combinations and Separations Do Not Give Rise to Transfers

Under § 1.987–2(c), an asset or liability is treated as transferred to a section 987 QBU from its owner if, as a result of a disregarded transaction, the asset or liability is reflected on the books and records of the section 987 QBU. Similarly, an asset or liability is treated as transferred from a section 987 QBU to its owner if, as a result of a disregarded transaction, the asset or liability is no longer reflected on the books and records of the section 987 QBU. For this purpose, a disregarded transaction generally means a transaction that is not regarded for Federal income tax purposes. Absent a special rule, the combination of multiple section 987 QBUs that have the same owner, or the separation of a section 987 QBU into two or more section 987 QBUs that have the same owner, would give rise to a transfer between an owner and one or more section 987 QBUs under the final regulations.

Consistent with the policy of deferring section 987 gain or loss under § 1.987–12T when assets of a section 987 QBU are reflected on the books and records of another section 987 QBU in the same controlled group as a result of certain transactions that result in deemed transfers, the Treasury Department and the IRS have determined that it would not be appropriate for combinations or separations of section 987 QBUs of the same owner to give rise to transfers to or from the section 987 QBUs. Accordingly, under the temporary regulations, section 987 gain or loss generally is not 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).

Specifically, notwithstanding the general rule of the final regulations, § 1.987–2T(c)(9)(i) provides that the combination of two or more combining QBUs that have the same owner into a combined QBU does not give rise to a transfer of any combining QBU's assets or liabilities to the owner. In addition, § 1.987–2T(c)(9)(i) provides that transactions between the combining QBUs occurring in the taxable year of the combination, which otherwise would give rise to transfers, do not result in a transfer of the combining QBUs' assets or liabilities to the owner under § 1.987–2(c). For this purpose, a combination occurs when the assets and liabilities that are properly reflected on the books and records of two or more combining QBUs begin to be properly reflected on the books and records of a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which combining QBUs become a combined QBU.

Similarly, § 1.987–2T(c)(9)(iii) provides that the separation of a separating QBU into two or more separated QBUs that have the same owner after the separation does not give rise to a transfer of any of the separating QBU's assets or liabilities to the owner. For this purpose, a separation occurs when assets and liabilities that are properly reflected on the books and records of a separating QBU begin to be properly reflected on the books and records of two or more separated QBUs. A separation may result from any transaction or series of transactions in which the separating QBU becomes two or more separated QBUs.

B. Determination of Net Unrecognized Section 987 Gain or Loss of Combined QBUs and Separated QBUs

The temporary regulations generally require combining the aggregate net unrecognized section 987 gain or loss of combining QBUs for purposes of determining net unrecognized section 987 gain or loss of the combined QBU and require apportioning the net unrecognized section 987 gain or loss of a separating QBU among separated QBUs in proportion to their respective shares of the aggregate adjusted basis of the separating QBU's gross assets. Specifically, § 1.987–4T(f)(1) provides that the net unrecognized section 987 gain or loss of a combined QBU for a taxable year is determined by taking into account the net accumulated unrecognized section 987 gain or loss of each combining QBU for all prior taxable years for which the final regulations apply and treating the combining QBUs as having combined immediately prior to the beginning of the taxable year of combination. Additionally, § 1.987–4T(f)(2) provides that the net unrecognized section 987 gain or loss of a separated QBU for a taxable year is determined by taking into account the separated QBU's share of the net accumulated unrecognized section 987 gain or loss of the separating QBU for all prior taxable years for which the final regulations apply and treating the separating QBU as having separated immediately prior to the beginning of the taxable year of separation. No transactions are deemed to occur between the separating QBUs in the taxable year of separation prior to the completion of the separation. A separated QBU's share of the separating QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is determined by apportioning the separating QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years 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 after the separation.

The temporary regulations also clarify at § 1.987–2T(c)(9)(ii) that, if a combining section 987 QBU has a different functional currency than the combined QBU, the combining section 987 QBU will be deemed to have automatically changed its functional currency to the functional currency of the combined section 987 QBU immediately prior to the combination. A combining section 987 QBU that is deemed to change its functional currency under this paragraph must make the adjustments described in § 1.985–5.

7. Translation of Foreign Taxes Claimed as a Foreign Tax Credit and Related Income

Under the general rule of § 1.987–3(c)(1), the owner of a section 987 QBU uses the yearly average exchange rate (as defined in § 1.987–1(c)(2)) to translate an item of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency. Alternatively, the owner of a section 987 QBU may elect to use the spot rate (as defined in § 1.987–1(c)(1)) for the day each item is taken into account.

Under section 986(a)(1)(A), for purposes of determining the amount of its foreign tax credit, a taxpayer that takes foreign income taxes into account when accrued generally translates the amount of any foreign income taxes (and any adjustments thereto) into dollars using the average exchange rate for the taxable year to which such taxes relate. However, sections 986(a)(1)(B) and (C) contain exceptions to this general rule, including for taxes that are not paid within two years of the close of the taxable year to which the taxes relate (two-year rule). In addition, section 986(a)(1)(D) provides that a taxpayer may elect to translate foreign income taxes denominated in a functional currency other than the taxpayer's functional currency using a spot rate in lieu of using the yearly average exchange rate. Section 986(a)(2)(A) generally provides that, for purposes of determining the amount of the foreign tax credit with respect to any foreign income taxes not subject to section 986(a)(1)(A) (or section 986(a)(1)(E), which provides a special rule for regulated investment companies), including by reason of the two-year rule or an election under section 986(a)(1)(D), the taxes are translated into dollars using the spot rate on the date such taxes were paid. Adjustments to such taxes are subject to the same rule, except that any refund or credit is translated into dollars using the exchange rate that applied to the original payment of such foreign income taxes.

Taking into account the translation rules of § 1.987–3(c) and section 986(a), a mismatch could arise between the owner functional currency value of income used to pay foreign income taxes and the owner functional currency value of the foreign income taxes claimed as a credit. In the case of foreign income taxes deemed paid under section 902, section 78 generally prevents such a mismatch at the level of the domestic shareholder claiming the credit by requiring the domestic shareholder to include in income an amount equal to the taxes deemed paid, but where a U.S. person claims a credit under section 901 that is not for taxes deemed paid under section 902 or section 960, foreign income taxes and the income used to pay those taxes could be translated at different translation rates. To address this potential mismatch, Notice 89–74, 1989–1 C.B. 739, provides that when a U.S. taxpayer with a foreign branch that has a functional currency other than the dollar claims a foreign tax credit with respect to a foreign tax, the taxpayer is required to translate a functional currency amount equal to the foreign taxes paid on branch income using the exchange rate at the time of payment of such taxes.

Consistent with Notice 89–74, § 1.987–3T(c)(2)(v) includes a special translation rule providing that income in an amount equal to the functional currency amount of the section 987 QBU's foreign income taxes claimed as a credit must be translated at the same rate used to translate the taxes. This translation rule applies to the owner of a section 987 QBU claiming a credit under section 901 for foreign income taxes, other than income taxes deemed paid under section 902 or section 960, that are properly reflected on the books of the section 987 QBU. Mechanically, this rule requires the owner to reduce the amount of section 987 taxable income or loss that otherwise would be determined under § 1.987–3 by an amount equal to the creditable tax amount, translated into U.S. dollars at the yearly average exchange rate for the taxable year in which the creditable tax is accrued, and then to increase the resulting amount by an amount equal to the creditable tax amount translated into U.S. dollars at the same exchange rate used to translate the creditable taxes into U.S. dollars under section 986(a). If the foreign taxes and the income are both translated at the same rate (that is, the same yearly average exchange rate), no adjustment is necessary under § 1.987–3T(c)(2)(v).

8. Determination of a Partner's Share of Assets and Liabilities of a Section 987 Aggregate Partnership

As discussed in the preamble to the final regulations, the final regulations apply an aggregate approach with respect to section 987 aggregate partnerships, which are defined in § 1.987–1(b)(5) as partnerships for which all of the capital and profits interests are owned, directly or indirectly, by persons that are related within the meaning of section 267(b) or section 707(b). This approach is consistent with the aggregate approach to partnerships reflected in the 2006 proposed regulations, but the 2006 proposed regulations would have applied to all partnerships. Under the aggregate approach, assets and liabilities reflected on the books and records of an eligible QBU of a partnership are allocated to each partner, which is considered an indirect owner of the eligible QBU. If the eligible QBU has a different functional currency than its indirect owner, then the assets and liabilities of the eligible QBU that are allocated to the partner are treated as a section 987 QBU of the indirect owner.

The 2006 proposed regulations provided a rule for determining a partner's share of the assets and liabilities of an eligible QBU that is owned indirectly through a section 987 aggregate partnership. Specifically, proposed § 1.987–7(b) provided that a partner's share of assets and liabilities reflected on the books and records of an eligible QBU owned through a section 987 aggregate partnership must be determined in a manner consistent with how the partners have agreed to share the economic benefits and burdens corresponding to partnership assets and liabilities, taking into account the rules and principles of subchapter K. One comment noted that this rule for allocating assets and liabilities to a partner's indirectly owned section 987 QBU was ambiguous and that the rules and principles of subchapter K do not provide sufficient guidance in this regard.

The Treasury Department and the IRS acknowledge the ambiguity in the 2006 proposed regulations regarding the manner in which assets and liabilities of a partnership are allocated to a partner's indirectly owned section 987 QBU under the aggregate approach. Accordingly, the temporary regulations provide more specific rules for determining a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership. Specifically, § 1.987–7T(b) provides that, in any taxable year, a partner's share of each asset and liability of a section 987 aggregate partnership is proportional to the partner's liquidation value percentage with respect to the aggregate partnership. A partner's liquidation value percentage is defined as the ratio of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of the partner's interest in the partnership is the amount of cash the partner would receive with respect to its interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752–7), paid an unrelated third party to assume all of its § 1.752–7 liabilities in a fully taxable transaction, and then liquidated.

In general, the temporary regulations provide that the determination date for determining a partner's liquidation value percentage is the date of the most recent event described in § 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (a revaluation event), irrespective of whether the capital accounts of the partners are adjusted under § 1.704–1(b)(2)(iv)(*f*), or, if there has been no revaluation event, the date of the formation of the partnership. However, if a partnership agreement provides for the allocation of any item of income, gain, deduction, or loss from partnership property to a partner other than in accordance with the partner's liquidation value percentage in a particular taxable year, the determination date is the last day of the partner's taxable year, or, if the partner's section 987 QBU owned indirectly through a section 987 aggregate partnership terminates during the partner's taxable year, the date such section 987 QBU is terminated. Without this requirement to redetermine liquidation value percentages at year-end when such an allocation is in effect, the allocation could result in section 987 taxable income or loss, which necessarily would reflect the allocation, being taken into account in determining section 987 gain or loss under § 1.987–4 even though the allocation was not taken into account in computing the owner functional currency value of the section 987 QBU, such that distortions would arise in the computation of section 987 gain or loss.

The Treasury Department and the IRS have determined that the liquidation value percentage methodology reflected in § 1.987–7T(b) reflects an administrable approach to allocating assets and liabilities of a section 987 aggregate partnership to eligible QBUs of its partners in a manner consistent with the partners' economic interests in the assets and liabilities of the partnership. The Treasury Department and the IRS request comments on the application of the liquidation value percentage approach reflected in the temporary regulations, including whether any alternative measure could better satisfy the criteria of administrability and consistency with the economics of the partners' arrangement.

9. Deferral of Certain Section 988 Loss Realized by a Debtor With Respect to a Related-Party Loan

Section 267(a)(1) provides that no deduction is allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons who have a relationship described in section 267(b). Section 267(f)(2) modifies the general rule of section 267(a)(1) in the case of a sale or exchange of property between corporations that are members of the same controlled group (as defined in section 267(f)(1)), generally providing that a loss realized upon such a sale or exchange is deferred until the property is transferred outside the group such that there would be recognition of loss under consolidated return principles. Section 267(f)(3)(C) provides that, to the extent provided in regulations, section 267(a)(1) does not apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of such controlled group if such loan is payable or denominated in a foreign currency and attributable to a reduction in the value of that foreign currency. Section 1.267(f)–1(e) provides that section 267(a) generally does not apply to an exchange loss realized with respect to a loan of nonfunctional currency to another controlled group member if the transaction that causes the realization of the loss does not have as a significant purpose the avoidance of Federal income tax. Additionally, § 1.267(f)–1(h) provides that if a transaction is engaged in with a principal purpose to avoid the purposes of § 1.267(f)–1, including by distorting the timing of losses, adjustments may be made to carry out such purposes. Section 1.988–2(b)(16)(i) cross-references the regulations under section 267 regarding the coordination of sections 267 and 988 with respect to the treatment of a creditor under a debt instrument, but § 1.988–2(b)(16)(ii) is reserved with respect to the treatment of a debtor. The temporary regulations correct the cross-reference in § 1.988–2(b)(16)(i) to refer to § 1.267(f)–1(e) rather than § 1.267(f)–1(h).

The Treasury Department and the IRS have determined that the policy considerations underlying section 267(f)(3)(C) and § 1.267(f)–1(e) with respect to creditors on loans to related persons also apply with respect to debtors on such loans and that there is no reason to distinguish between a creditor and debtor with regard to the application of an anti-avoidance rule to the same transaction. Accordingly, pursuant to the authority granted to the Secretary in section 989(c)(5) to prescribe regulations providing for the appropriate treatment of related-party transactions, § 1.988–2T(b)(16)(ii) provides that exchange loss of a debtor with respect to a loan (original loan) from a person with whom the debtor has a relationship described in section 267(b) or section 707(b) is deferred if the transaction resulting in realization of the loss has a principal purpose of avoiding Federal income tax. Such deferred loss will be recognized at the end of the term of the original loan.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), please refer to the Special Analyses section in the preamble to the cross-referenced notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Mark E. Erwin of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 985, 987, 989(c) and 7805 * * *

■ **Par. 2.** Section 1.987–0 is amended by adding entries for §§ 1.987–6(b)(4) and 1.987–12(a) through (h) to read as follows:

§ 1.987–0 Section 987; table of contents.

* * * * *

§ 1.987–6 Character and source of section 987 gain or loss.

* * * * *

(b) * * *

(4) [Reserved].

* * * * *

§ 1.987–12 Deferral of section 987 gain or loss.

(a) through (h) [Reserved].

■ **Par. 3.** Section 1.987–1 is amended by adding paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(B) and (C), and (g)(3)(i)(E) through (H) to read as follows:

§ 1.987–1 Scope, definitions, and special rules.

* * * * *

(b) * * *

(1) * * *

(iii) [Reserved]. For further guidance, see § 1.987–1T(b)(1)(iii).

* * * * *

(b) * * *

(6) [Reserved]. For further guidance, see § 1.987–1T(b)(6).

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(B) [Reserved]. For further guidance, see § 1.987–1T(c)(1)(ii)(B).

* * * * *

(c) * * *

(3) * * *

(i) * * *

(E) [Reserved]. For further guidance, see § 1.987–1T(c)(3)(i)(E).

* * * * *

(d) * * *

(3) [Reserved]. For further guidance, see § 1.987–1T(d)(3).

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(f) [Reserved]. For further guidance, see § 1.987–1T(f).

* * * * *

(g) * * *

(2) * * *

(i) * * *

(B) through (C) [Reserved]. For further guidance, see § 1.987–1T(g)(2)(i)(B) through (C).

* * * * *

(g) * * *

(3) * * *

(i) * * *

(E) through (H) [Reserved]. For further guidance, see § 1.987–1T(g)(3)(i)(E) through (H).

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■ **Par. 4.** Section 1.987–1T is added to read as follows:

§ 1.987–1T Scope, definitions, and special rules (temporary).

(a) through (b)(1)(ii) [Reserved]. For further guidance, see § 1.987–1(a) through (b)(1)(ii).

(iii) *Certain provisions applicable to all taxpayers.* Notwithstanding § 1.987–1(b)(1)(ii), paragraphs (b)(6) and (g)(3)(i)(E) of this section and § 1.987–6T(b)(4) apply to any taxpayer that is an owner of a dollar QBU (as defined in paragraph (b)(6) of this section), and paragraphs (g)(2)(i)(B) and (g)(3)(i)(H) of this section and §§ 1.987–8T(d) and 1.987–12T apply to any taxpayer that is an owner of an eligible QBU (determined without regard to § 1.987–1(b)(3)(ii)) that is subject to section 987.

(b)(2) through (b)(5) [Reserved]. For further guidance, see § 1.987–1(b)(2) through (b)(5).

(6) *Dollar QBUs*—(i) *In general.* Except as provided in paragraphs (b)(1)(iii) and (b)(6)(iii) of this section, section 987 and the regulations thereunder do not apply with respect to an eligible QBU (determined without regard to § 1.987–1(b)(3)(ii)) that has the U.S. dollar as its functional currency and that would be subject to section 987 if it had a functional currency other than the dollar (dollar QBU). This paragraph (b)(6) applies to all taxpayers, including entities described in § 1.987–1(b)(1)(ii).

(ii) *Application of section 988 to a dollar QBU*—(A) *In general.* Except as provided in paragraphs (b)(6)(ii)(B) and (b)(6)(iii) of this section, a controlled foreign corporation (as defined in section 957(a)) (CFC) that is the owner of a dollar QBU applies section 988 with respect to any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU. Except as provided in paragraph (b)(6)(ii)(B) of this section, for purposes of determining the amount of section 988 gain or loss of the CFC, any item that is properly reflected on the books and records of the dollar QBU and that would give rise to a section 988 transaction if such item were acquired, accrued, or entered into directly by the owner of the dollar QBU is treated as properly reflected on the books and records of the owner of the dollar QBU, such that the amount of section 988 gain or loss with respect to such item is determined by reference to the owner's functional currency.

(B) *Section 988 gain or loss characterized as effectively connected income.* Solely for the purpose of determining the amount of section 988 gain or loss of a CFC described in paragraph (b)(6)(ii)(A) of this section that is effectively connected with the conduct of a trade or business within the United States (ECI), any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under § 1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar.

(iii) *Election for a CFC to apply section 987 to a dollar QBU*—(A) *In general.* A CFC that is the owner of a dollar QBU may elect to apply section 987 and the regulations thereunder with respect to the dollar QBU in lieu of applying section 988 pursuant to paragraph (b)(6)(ii) of this section. If the dollar QBU or CFC is described in § 1.987–1(b)(1)(ii), however, the CFC must apply section 987 to the dollar QBU using the method it applied to the dollar QBU immediately prior to the effective date of this paragraph (b)(6) as provided in paragraph (h) of this section, provided such method was a reasonable interpretation of section 987, or, if no such method exists, a reasonable method.

(B) *Section 988 gain or loss characterized as effectively connected income.* Solely for the purpose of determining the amount of section 988 gain or loss of a dollar QBU that is the subject of an election described in paragraph (b)(6)(iii)(A) of this section that is ECI, § 1.987–3T(b)(4)(i) and (ii) do not apply, and any section 988 gain or loss that would be determined under section 988 as a result of the acquisition or accrual of any item and treated as ECI under § 1.988–4(c) if the item were treated as properly reflected on the books and records of the dollar QBU is determined by treating such item as properly reflected on the books and records of the dollar QBU. Consequently, solely for that purpose, such section 988 gain or loss is determined by reference to the U.S. dollar. See § 1.987–6T(b)(4) for rules regarding the source of section 987 gain or loss with respect to a dollar QBU for which the CFC owner has made the election described in this paragraph.

(b)(7) through (c)(1)(ii)(A) [Reserved]. For further guidance, see § 1.987–1(b)(7) through (c)(1)(ii)(A).

(B) *Election inapplicable with respect to certain amounts.* Except as provided in this paragraph (c)(1)(ii)(B), the election provided in § 1.987–1(c)(1)(ii)(A) does not apply for purposes of determining section 987 taxable income or loss (as defined in § 1.987–3(a)) with respect to a historic item (as defined in § 1.987–1(e)) if acquiring, accruing, or entering into such item gives rise to a section 988 transaction or specified owner functional currency transaction. However, the election provided in § 1.987–1(c)(1)(ii)(A) does apply for purposes of determining section 987 taxable income or loss with respect to a payable or receivable described in § 1.988–1(d)(3) under the circumstances described in § 1.988–1(d)(3).

(c)(2) through (c)(3)(i)(D) [Reserved]. For further guidance, see § 1.987–1(c)(2) through (c)(3)(i)(D).

(E) *Section 988 transactions and specified owner functional currency transactions.* If acquiring, accruing, or entering into a historic item gives rise to a section 988 transaction of a section 987 QBU or a specified owner functional currency transaction described in § 1.987–3T(b)(4)(ii), the historic rate is the spot rate (as defined in paragraph (c)(1) of this section) on the date such item is acquired, accrued, or entered into. For this purpose, use of a spot rate convention under § 1.987–1(c)(1)(ii) is permitted only with respect to a payable or receivable described in § 1.988–1(d)(3) and only to the extent provided therein.

(c)(3)(ii) through (d)(2) [Reserved]. For further guidance, see § 1.987–1(c)(3)(ii) through (d)(2).

(3) Gives rise to a qualified short-term section 988 transaction (as defined in § 1.987–3T(b)(4)(iii)(B)) of the section 987 QBU, whether denominated in the functional currency of the owner or other nonfunctional currency with respect to the section 987 QBU, for which section 988 gain or loss is determined under § 1.987–3T(b)(4)(iii)(A) in, and by reference to, the functional currency of the section 987 QBU.

(e) [Reserved]. For further guidance, see § 1.987–1(e).

(f) *Examples.* The following examples illustrate the application of § 1.987–1(d) and (e).

Example 1. U.S. Corp is a domestic corporation with the U.S. dollar as its functional currency and is the owner of Business A, a section 987 QBU that has the pound as its functional currency. Assume all transactions of Business A are entered into in the ordinary course of its business. U.S. Corp has not made an election under § 1.987–3T(b)(4)(iii)(C) to adopt a foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions. Items reflected on Business A's balance sheet include £10,000, $1,000, a building with a basis of £100,000, a light general purpose truck with a basis of £30,000, a computer with a basis of £1,000, a 60-day receivable for ¥15,000, an account payable of £5,000, and a foreign currency contract within the meaning of section 1256(g)(2) that requires Business A to exchange £100 for $125 in 90 days. Under paragraph (d) of this section, the £10,000, the £5,000 account payable and the £/$ section 1256 foreign currency contract are marked items. The other items are historic items under this paragraph (e) of this section.

Example 2. The facts are the same as *Example 1* except that U.S. Corp has elected under § 1.987–3T(b)(4)(iii)(C) to adopt the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions of Business A. Under paragraphs (d) and (e) of this section, the £10,000, the $1,000, the ¥15,000 receivable, the £5,000 account payable, and the £/$ section 1256 foreign currency contract are marked items.

(g)(1) through (g)(2)(i)(A) [Reserved]. For further guidance, see § 1.987–1(g)(1) through (g)(2)(i)(A).

(B) *Annual deemed termination election*—(*1*) *In general.* Except as provided in paragraph (g)(2)(i)(B)(*2*) of this section, an election under § 1.987–8T(d) (annual deemed termination election) applies to all section 987 QBUs owned by the taxpayer, as well as to all section 987 QBUs owned by any person that has a relationship to the taxpayer described in section 267(b) or section 707(b) (substituting ''and the profits interest'' for ''or the profits interest'' in section 707(b)(1)(A) and substituting ''and profits interests'' for ''or profits interests'' in section 707(b)(1)(B)) on the last day of the first taxable year for which the election applies (a related person). If a taxpayer makes the election under § 1.987–8T(d), the first taxable year of a related person for which the election applies is the first taxable year that ends with or within a taxable year of the taxpayer for which the taxpayer's election applies. An election under § 1.987–8T(d) may not be revoked.

(*i*) *Fresh start taxpayers.* A taxpayer to which § 1.987–10 applies that is required under § 1.987–10(a) to apply the fresh start transition method described in § 1.987–10(b) (fresh start taxpayer) may make the election under § 1.987–8T(d) only if the first taxable year for which the election would apply to the taxpayer is either the first taxable year beginning on or after the transition date (as defined in § 1.987–11(c)) in which the election is relevant or a subsequent taxable year in which the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million. For purposes of this paragraph (g)(2)(i)(B), a taxpayer's controlled group aggregate section 987 loss means the aggregate net amount of section 987 loss that would be recognized pursuant to the election by the taxpayer and all other persons to whom the taxpayer's election would apply in the first taxable year of each person for which the election would apply.

(*ii*) *Other taxpayers.* Other taxpayers, including taxpayers described in § 1.987–1(b)(1)(ii) and taxpayers described in § 1.987–10(c), must follow the election rules provided in paragraph (g)(2)(i)(B)(*1*)(*i*) of this section if any related party is a fresh start taxpayer. If no related party is a fresh start taxpayer, the election under § 1.987–8T(d) may be made only if the first taxable year for which the election would apply to the taxpayer is either the first taxable year beginning on or after December 7, 2016, in which the election is relevant or a subsequent taxable year in which the taxpayer's controlled group aggregate section 987 loss, if any, does not exceed $5 million.

(*2*) *QBU-by-QBU elections in certain circumstances.* Notwithstanding paragraph (g)(2)(i)(B)(*1*) of this section, a taxpayer may make a separate election under § 1.987–8T(d) with respect to any section 987 QBU owned by the taxpayer if the first taxable year for which the election would apply to the taxpayer with respect to the section 987 QBU is a taxable year in which there is a section 987 gain recognized with respect to the section 987 QBU pursuant to the election, or is a taxable year in which there is a section 987 loss of $1 million or less that would be recognized with respect to the section 987 QBU pursuant to the election

(C) *Election to translate all items at the yearly average exchange rate.* An election under § 1.987–3T(d) (election to translate all items at the yearly average exchange rate) may be made with respect to a section 987 QBU only if the first taxable year for which the election would apply is the first taxable year for which an election under § 1.987–8T(d) (annual deemed termination election) applies with respect to the section 987 QBU.

(g)(2)(ii) through (g)(3)(i)(D) [Reserved]. For further guidance, see § 1.987–1(g)(2)(ii) through (g)(3)(i)(D).

(E) *Election for a CFC to apply section 987 to a dollar QBU.* An election under § 1.987–1T(b)(6)(iii) for a CFC to apply section 987 to a dollar QBU must be titled ''Section 987 Election for a CFC to Apply Section 987 to a Dollar QBU Under § 1.987–1T(b)(6)(iii)'' and must provide the name and address of each QBU for which the election is being made.

(F) *Election to apply the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions.* An election under § 1.987–3T(b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions must be titled ''Section 987 Election to Use Foreign Currency Mark-to-Market Method of Accounting for Qualified Short-Term Section 988 Transactions Under § 1.987–3(b)T(4)(iii)(C)'' and must provide the name and address of each section 987 QBU for which the election is being made.

(G) *Election to translate all items at the yearly average exchange rate.* An election under § 1.987–3T(d) to translate all items at the yearly average exchange rate must be titled ''Section 987 Election to Translate All Items at the Yearly Average Exchange Rate Under § 1.987–3T(d)'' and must provide the name and address of each section 987 QBU for which the election is being made.

(H) *Annual deemed termination election.* An election under § 1.987–8T(d) for an owner to deem all of its section 987 QBUs to terminate on the last day of each taxable year must be titled ''Section 987 Annual Deemed Termination Election Under § 1.987–8T(d)'' and must provide the name and address of each section 987 QBU to which the election applies, including a section 987 QBU owned by a related person (within the meaning of paragraph (g)(2)(i)(B)(*1*) of this section).

(g)(4) through (6) [Reserved]. For further guidance, see § 1.987–1(g)(4) through (6).

(h) *Effective/applicability date.* Paragraphs (g)(2)(i)(B) and (g)(3)(i)(H) of this section apply to the first taxable year beginning on or after December 7, 2016. Paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(C), and (g)(3)(i)(E) through (G) of this section apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then paragraphs (b)(1)(iii), (b)(6), (c)(1)(ii)(B), (c)(3)(i)(E), (d)(3), (f), (g)(2)(i)(C), and (g)(3)(i)(E) through (G) of this section apply to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(i) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 5.** Section 1.987–2 is amended by adding paragraph (c)(9) to read as follows:

§ 1.987–2 Attribution of items to eligible QBUs; definition of a transfer and related rules.

* * * * *

(c) * * *

(9) [Reserved]. For further guidance, see § 1.987–2T(c)(9).

* * * * *

■ **Par. 6.** Section 1.987–2T is added to read as follows:

§ 1.987–2T Attribution of items to eligible QBUs; definition of a transfer and related rules (temporary).

(a) through (c)(8) [Reserved]. For further guidance, see § 1.987–2(a) through (c)(8).

(9) *Certain disregarded transactions not treated as transfers*—(i) *Combinations of section 987 QBUs.* The combination of two or more separate section 987 QBUs (combining QBUs) that are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, into one section 987 QBU (combined QBU) does not give rise to a transfer of any combining QBU's assets or liabilities to the owner under § 1.987–2(c). In addition, transactions between the combining QBUs occurring in the taxable year of the combination do not result in a transfer of the combining QBUs' assets or liabilities to the owner under § 1.987–2(c). For this purpose, a combination occurs when the assets and liabilities that are properly reflected on the books and records of two or more combining QBUs begin to be properly reflected on the books and records of a combined QBU and the separate existence of the combining QBUs ceases. A combination may result from any transaction or series of transactions in which the combining QBUs become a combined QBU. For rules regarding the determination of net unrecognized section 987 gain or loss of a combined QBU, see § 1.987–4T(f)(1).

(ii) *Change in functional currency from a combination.* If, following a combination of section 987 QBUs described in paragraph (c)(9)(i) of this section, the combined section 987 QBU has a different functional currency than one or more of the combining section 987 QBUs, any such combining section 987 QBU is treated as changing its functional currency and the owner of the combined section 987 QBU must comply with the regulations under section 985 regarding the change in functional currency. See §§ 1.985–1(c)(6) and 1.985–5.

(iii) *Separation of section 987 QBUs.* The separation of a section 987 QBU (separating QBU) into two or more section 987 QBUs (separated QBUs) that, after the separation, are directly owned by the same owner, or that are indirectly owned by the same partner through a single section 987 aggregate partnership, does not give rise to a transfer of the separating QBU's assets or liabilities to the owner under § 1.987–2(c). Additionally, transactions that occurred between the separating QBUs in the taxable year of the separation prior to the completion of the separation do not give rise to transfers for purposes of section 987. For this purpose, a separation occurs when the assets and liabilities that are properly reflected on the books and records of a separating QBU begin to be properly reflected on the books and records of two or more separated QBUs. A separation may result from any transaction or series of transactions in which a separating QBU becomes two or more separated QBUs. A separation may also result when a section 987 QBU that is subject to a grouping election under § 1.987–1(b)(2)(ii)(A) changes its functional currency. For rules regarding the determination of net unrecognized section 987 gain or loss of a separated QBU, see § 1.987–4T(f)(2).

(c)(10) through (d) [Reserved]. For further guidance see § 1.987–2(c)(10) through (d).

(e) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(f) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 7.** Section 1.987–3 is amended by adding paragraphs (b)(2)(ii), (b)(4), (c)(2)(ii) and (v), and (d), and *Example 9* through *Example 14* at the end of paragraph (e) to read as follows:

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

* * * * *

(b) * * *

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.987–3T(b)(2)(ii).

* * * * *

(b) * * *

(4) [Reserved]. For further guidance, see § 1.987–3T(b)(4).

* * * * *

(c) * * *

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.987–3T(c)(2)(ii).

* * * * *

(c) * * *

(2) * * *

(v) through (d) [Reserved]. For further guidance, see § 1.987–3T(c)(2)(v) through (d).

(e) *Examples.* * * *

Example 9 through *Example 14* [Reserved]. For further guidance, see § 1.987–3T(e), *Example 9* through *Example 14.*

■ **Par. 8.** Section 1.987–3T is added to read as follows:

§ 1.987–3T Determination of section 987 taxable income or loss of an owner of a section 987 QBU (temporary).

(a) through (b)(2)(i) [Reserved]. For further guidance, see § 1.987–3(a) through (b)(2)(i).

(ii) *No translation of basis or amount realized with respect to a specified owner functional currency transaction treated as a historic asset.* If the acquisition of a historic asset gives rise to a specified owner functional currency transaction described in paragraph (b)(4)(ii) of this section, the basis of the historic asset, and any amount realized on a disposition of the historic asset, is not translated if the amount is denominated in the owner's functional currency.

(3) [Reserved]. For further guidance, see § 1.987–3(b)(3).

(4) *Special rule for section 988 transactions*—(i) *In general.* Section 988 and the regulations thereunder apply to section 988 transactions of a section 987 QBU. For this purpose, whether a transaction is a section 988 transaction is determined by reference to the functional currency of the section 987 QBU. (But see paragraph (b)(4)(ii) of this section, providing that specified owner functional currency transactions are not treated as section 988 transactions.) However, except as provided in paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss is determined in, and by reference to, the functional currency of the owner of the section 987 QBU rather than the functional currency of the section 987 QBU. Accordingly, in determining section 988 gain or loss of a section 987 QBU with respect to a section 988 transaction of the section 987 QBU, the amounts required under section 988 and the regulations thereunder to be translated on the

applicable booking date or payment date with respect to the section 988 transaction are translated into the owner's functional currency at the rate required under section 988 and the regulations thereunder.

(ii) *Specified owner functional currency transactions not treated as section 988 transactions.* Transactions of a section 987 QBU described in sections 988(c)(1)(B)(i), 988(c)(1)(B)(ii), and 988(c)(1)(C) (including the acquisition of nonfunctional currency as described in § 1.988–1(a)(1)), other than transactions described in paragraph (b)(4)(iii)(A) of this section, that are denominated in (or determined by reference to) the owner's functional currency (specified owner functional currency transactions) are not treated as section 988 transactions. Thus, no currency gain or loss is recognized by a section 987 QBU under section 988 with respect to such transactions.

(iii) *Determination of section 988 gain or loss for qualified short-term section 988 transactions*—(A) *Determination by reference to the section 987 QBU's functional currency for certain transactions subject to a mark-to-market method of accounting.* Section 988 gain or loss with respect to section 988 transactions described in paragraph (b)(4)(iii)(B) of this section that are accounted for under a mark-to-market method of accounting for Federal income tax purposes or under the foreign currency mark-to-market method of accounting described in paragraph (b)(4)(iii)(C) of this section, and any hedges entered into to manage risk with respect to such transactions within the meaning of § 1.1221–2(c)(4) (related hedges), must be determined in, and by reference to, the functional currency of the section 987 QBU (rather than the functional currency of its owner).

(B) *Qualified short-term section 988 transaction.* A qualified short-term section 988 transaction is a section 988 transaction that occurs in the ordinary course of a section 987 QBU's business and has an original term of one year or less on the date the transaction is entered into by the section 987 QBU. The holding of currency that is nonfunctional currency (within the meaning of section 988(c)(1)(C)(ii)) to the section 987 QBU in the ordinary course of a section 987 QBU's trade or business also is treated as a qualified short-term section 988 transaction. Any transaction that is denominated in, or determined by reference to, a hyperinflationary currency, including the holding of hyperinflationary currency, is not considered a qualified short-term section 988 transaction. See §§ 1.988–2(b)(15), 1.988–2(d)(5), and 1.988–2(e)(7) for rules relating to transactions denominated in, or determined by reference to, a hyperinflationary currency.

(C) *Election to use a foreign currency mark-to-market method of accounting.* A taxpayer may elect under this paragraph (b)(4)(iii)(C) to apply the foreign currency mark-to-market method of accounting described in this paragraph for all qualified short-term section 988 transactions described in paragraph (b)(4)(iii)(B) of this section, and any related hedges, that are properly attributable to a section 987 QBU on or after the effective date of the election and that are not otherwise accounted for under a mark-to-market method of accounting under section 475 or section 1256. Under the foreign currency mark-to-market method of accounting, the timing of section 988 gain or loss on section 988 transactions is determined under the principles of section 1256(a)(1). Thus, only section 988 gain or loss is taken into account under the foreign currency mark-to-market method of accounting. Appropriate adjustments must be made to prevent the section 988 gain or loss from being taken into account again under section 988 or another provision of the Code or regulations. A section 988 transaction subject to this election is not subject to the ''netting rule'' of section 988(b) and § 1.988–2(b)(8), under which exchange gain or loss is limited to overall gain or loss realized in a transaction, in taxable years prior to the taxable year in which section 988 gain or loss would be recognized with respect to such section 988 transaction but for this election.

(iv) *Examples.* Examples 10 through 13 of paragraph (e) of this section illustrate the application of this paragraph (b)(4).

(c)(1) through (c)(2)(i) [Reserved]. For further guidance, see § 1.987–3(c)(1) through (c)(2)(i).

(ii) *Amount realized with respect to historic assets that are section 988 transactions.* If the acquisition of a historic asset gave rise to a section 988 transaction described in paragraph (b)(4)(i) of this section, then in computing the total gain or loss on a disposition of the historic asset (some or all of which total gain or loss may be section 988 gain or loss described in section 988(b) and paragraph (b)(4)(i) of this section), the amount realized (determined, if necessary, under § 1.987–3(b)(2)(i)) is translated into the owner's functional currency using the spot rate on the date such item is properly taken into account, subject to the limitation under § 1.987–1T(c)(1)(ii)(B) regarding the use of a spot rate convention.

(iii) through (iv) [Reserved]. For further guidance, see § 1.987–3(c)(2)(iii) through (iv).

(v) *Translation of income to account for certain foreign income tax claimed as a credit.* The owner of a section 987 QBU claiming a credit under section 901 for foreign income taxes, other than foreign income taxes deemed paid under section 902 or section 960, that are properly reflected on the books and records of the section 987 QBU (the creditable tax amount) must determine section 987 taxable income or loss attributable to the section 987 QBU by reducing the amount of section 987 taxable income or loss that otherwise would be determined under this section by an amount equal to the creditable tax amount, translated into U.S. dollars using the yearly average exchange rate for the taxable year in which the creditable tax is accrued, and by increasing the resulting amount by an amount equal to the creditable tax amount, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a). See *Example 14* of paragraph (e) of this section,, for an illustration of this rule.

(d) *Election to translate all items at the yearly average exchange rate.* Notwithstanding § 1.987–3(c), a taxpayer that has made the annual deemed termination election described in § 1.987–8T(d) may elect under this paragraph (d) to translate all items of income, gain, deduction, and loss with respect to a section 987 QBU determined under § 1.987–3(b) in the functional currency of the section 987 QBU into the owner's functional currency, if necessary, at the yearly average exchange rate for the taxable year. *Example 9* of paragraph (e) of this section illustrates the application of this election.

(e) *Example 1* through *Example 8* [Reserved]. For further guidance, see § 1.987–3(e), *Example 1* through *Example 8*.

Example 9. The facts are the same as in *Example 7,* except that U.S. Corp properly elects under paragraph (d) of this section to translate all items of income, gain, deduction, and loss with respect to Business A at the yearly average exchange rate. Accordingly, Business A's €2,000 gain on the sale of the land is translated at the yearly average exchange rate for 2021 of €1 = $1.05, and the amount of gain reported by U.S. Corp on the sale of the land is $2,100.

Example 10. Business A acquires £100 on August 27, 2021, for €120 and sells the pounds on November 17, 2021, for €125. The dollar-pound spot rate (without the use of a spot rate convention) is £1 = $1 on August

27, 2021, and £1 = $1.10 on November 17, 2021. The disposition of the pounds is a section 988 transaction of Business A under paragraph (b)(4)(i) of this section, and the pounds are a historic asset under § 1.987–1(e). Section 988 gain or loss with respect to the disposition of the pounds is determined under paragraph (b)(4)(i) of this section and § 1.988–2(a)(2) by reference to the dollar functional currency of Business A's owner. The dollar amount realized for the pounds is determined under paragraph (c)(2)(ii) of this section by translating £100 into $110 using the dollar-pound spot rate on November 17, 2021, without the use of a spot rate convention. The dollar basis in the pounds is determined under § 1.987–3(c)(2)(i) by translating £100 into $100 using the historic rate described in § 1.987–1T(c)(3)(i)(E), which is the dollar-pound spot rate on August 27, 2021, without the use of a spot rate convention. Thus, U.S. Corp takes into account $10 of section 988 gain with respect to Business A's disposition of £100.

Example 11. (i) Business A purchases a £100 2-year note for €75 on October 1, 2021, and receives a £100 repayment of principal with respect to the note on December 31, 2021. At the spot rates on October 1, 2021 (as defined in § 1.987–1(c)(1)), without the use of a spot rate convention, Business A's €75 purchase price translates into £80 and $95. At the spot rates on December 31, 2021, without the use of a spot rate convention, the £100 principal amount on the note translates into €90 and $130, and £80 translates into $104.

(ii) The acquisition of the note is a section 988 transaction of Business A under paragraph (b)(4)(i) of this section, and the note is a historic asset under § 1.987–1(e). To determine its section 987 taxable income or loss with respect to Business A, U.S. Corp must determine Business A's total gain or loss on the disposition of the note in U.S. Corp's dollar functional currency. Consistent with § 1.988–2(b)(8), U.S. Corp also must determine whether some or all of that gain or loss constitutes section 987 gain or loss described in section 988(b).

(iii) To determine Business A's total gain or loss on the disposition of the note, Business A's basis and amount realized on the note must be determined in euros under § 1.987–3(b), if necessary, and translated into dollars under § 1.987–3(c). Business A has a €75 basis in the note that is translated into $95 under § 1.987–3(c)(2)(i) at the historic rate described in § 1.987–1T(c)(3)(i)(E), which is the spot rate on the date the note was acquired without the use of a spot rate convention. Business A's £100 amount realized on the note is translated into €90 under § 1.987–3(b)(2)(i) using the spot rate on December 31, 2021, without the use of a spot rate convention. That €90 amount realized is then translated into $130 under paragraph (c)(2)(ii) of this section using the spot rate on December 31, 2021, without the use of a spot rate convention. Accordingly, the total gain with respect to the disposition of the note that is included in section 987 taxable income is $35 ($130 less $95).

(iv) U.S. Corp must determine whether some or all of the $35 total gain with respect to the note constitutes section 988 gain. The amount of section 988 gain realized with respect to the note is determined under § 1.988–2(b)(5), which requires a comparison of the functional currency value of the principal amount of the note on the booking date and payment date spot rates, respectively, and defines the principal amount of the note as Business A's purchase price in units of nonfunctional currency, which is £80. Under paragraph (b)(4)(i) of this section, section 988 gain or loss with respect to the note is determined by reference to U.S. Corp's dollar functional currency, such that the amounts required under section 988 to be translated on the booking date and payment date are translated into the dollars at the booking date and payment date spot rates. Accordingly, Business A's £80 principal amount with respect to the note is translated at the booking date and payment date spots rates into $95 and $104, respectively. Thus, $9 ($104 less $95) of the $35 total gain taken into account by U.S. Corp as section 987 taxable income with respect to the note is section 988 gain. The remaining $26 of gain, which may be attributable to credit risk or another factor unrelated to currency fluctuations, is sourced and characterized without regard to section 988.

Example 12. The facts are the same as in *Example 11,* except that Business A is owned by a foreign corporation with a pound functional currency. Under paragraph (b)(4)(ii) of this section, the acquisition of the £100 2-year note is a specified owner functional currency transaction that is not treated as a section 988 transaction of Business A. Because the note is a historic asset under § 1.987–1(e), Business A's €75 basis in the note translates into £80 at the historic rate described in § 1.987–1T(c)(3)(i)(E), which provides that the historic rate is the spot rate for the date the note was acquired without the use of a spot rate convention. (If, instead, Business A had purchased the 5-year note for £80 rather than €75, then pursuant to paragraph (b)(2)(ii) of this section, Business A's basis in the note would have been determined without translating the £80 purchase price because it is denominated in the owner's functional currency.) Under paragraph (b)(2)(ii) of this section, the £100 amount realized with respect to the note is not translated because it is denominated in the owner's functional currency. Thus, the owner takes into account £20 (£100 less £80) of section 987 taxable income in 2021 with respect to the note.

Example 13. (i) Business A receives and accrues $100 of income from the provision of services on January 1, 2021. Business A continues to hold the $100 as a U.S. dollar-denominated demand deposit at a bank on December 31, 2021. U.S. Corp has elected under paragraph (b)(4)(iii)(C) of this section to use the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions entered into by Business A. The euro-dollar spot rate without the use of a spot rate convention is €1 = $1 on January 1, 2021, and €1 = $2 on December 31, 2021, and the yearly average exchange rate for 2021 is €1 = $1.50.

(ii) Under § 1.987–3(b)(2)(i), the $100 earned by Business A is translated into €100 at the spot rate on January 1, 2021, as defined in § 1.987–1(c)(1) without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €100 of service income is translated into $150 at the yearly average exchange rate for 2021, as provided in § 1.987–3(c)(1).

(iii) The $100 demand deposit constitutes a qualified short-term section 988 transaction under paragraph (b)(4)(iii)(B) of this section because the demand deposit is treated as nonfunctional currency within the meaning of section 988(c)(1)(C)(ii). Because Business A uses the foreign currency mark-to-market method of accounting for qualified short-term section 988 transactions, under paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss for such transactions is determined in, and by reference to, euros, the functional currency of Business A. Accordingly, section 988 gain or loss must be determined on Business A's holding of the $100 demand deposit in, and by reference to, the euro. Under § 1.988–2(a)(2), Business A is treated as having an amount realized of €50 when the $100 is marked to market at the end of 2021 under paragraph (b)(4)(iii)(C) of this section. Marking the dollars to market gives rise to a section 988 loss of €50 (€50 amount realized, less Business A's €100 basis in the $100). In determining U.S. Corp's taxable income, that €50 loss is translated into a $75 loss at the yearly average exchange rate for 2021, as provided in § 1.987–3(c)(1).

Example 14. (i) *Facts.* Business A earns €100 of revenue from the provision of services and incurs €30 of general expenses and €10 of depreciation expense during 2021. Except as otherwise provided, U.S. Corp uses the yearly average exchange rate described in § 1.987–1(c)(2) to translate items of income, gain, deduction, and loss of Business A. Business A is subject to income tax in Country X at a 25 percent rate. U.S. Corp claims a credit with respect to Business A's foreign income taxes and elects under section 986(a)(1)(D) to translate the foreign income taxes at the spot rate on the date the taxes were paid. The yearly average exchange rate for 2021 is €1 = $1.50. The historic rate used to translate the depreciation expense is €1 = $1.00. The spot rate on the date that Business A paid its foreign income taxes was €1 = $1.60.

(ii) *Analysis.* Because U.S. Corp has elected to translate foreign income taxes at the spot rate on the date such taxes were paid rather than at the yearly average exchange rate, U.S. Corp must make the adjustments described in paragraph (c)(2)(v) of this section. Accordingly, U.S. Corp determines its section 987 taxable income by reducing the section 987 taxable income or loss that otherwise would be determined under this section by €15, translated into U.S. dollars at the yearly average exchange rate (€1 = $1.50), and increasing the resulting amount by €15, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a) (€1 = $1.60). Following these adjustments, Business A's section 987 taxable income for 2021 is $96.50, computed as follows:

	Amount in €	Translation rate	Amount in $
Revenue	€100	€1 = $1.50	$150.00
General Expenses	(30)	€1 = $1.50	(45.00)
Depreciation	(10)	€1 = $1.00	(10.00)
Tentative section 987 taxable income	€60		$95.00
Adjustments under paragraph (c)(2)(v) of this section:			
Decrease by €15 tax translated at yearly average exchange rate (€1 = $1.50)			($22.50)
Increase by €15 tax translated at spot rate on payment date (€1 = $1.60)			24.00
Section 987 taxable income			$96.50

(f) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(g) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 9.** Section 1.987–4 is amended by adding paragraphs (c)(2) and (f) to read as follows:

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

* * * * *

(c) * * *

(2) [Reserved]. For further guidance, see § 1.987–4T(c)(2).

* * * * *

(f) [Reserved]. For further guidance, see § 1.987–4T(f).

* * * * *

■ **Par. 10.** Section 1.987–4T is added to read as follows:

§ 1.987–4T Determination of net unrecognized section 987 gain or loss of a section 987 QBU (temporary).

(a) through (c)(1) [Reserved]. For further guidance, see § 1.987–4(a) through (c)(1).

(2) *Coordination with § 1.987–12T.* For purposes of paragraph (c)(1) of this section, amounts taken into account under § 1.987–5 are determined without regard to § 1.987–12T.

(d) through (e) [Reserved]. For further guidance, see § 1.987–4(d) through (e).

(f) *Combinations and separations*—(1) *Combinations.* The net unrecognized section 987 gain or loss of a combined QBU (as defined in § 1.987–2T(c)(9)(i)) for a taxable year is determined under § 1.987–4(b) by taking into account the net accumulated unrecognized section 987 gain or loss of each combining QBU (as defined in § 1.987–2T(c)(9)(i)) for all prior taxable years to which the regulations under section 987 apply, as determined under § 1.987–4(c), and by treating the combining QBUs as having combined immediately prior to the beginning of the taxable year of combination.

(2) *Separations.* The net unrecognized section 987 gain or loss of a separated QBU (as defined in § 1.987–2T(c)(9)(iii)) for a taxable year is determined under § 1.987–4(b) by taking into account the separated QBU's share of the net accumulated unrecognized section 987 gain or loss of the separating QBU (as defined in § 1.987–2T(c)(9)(iii)) for all prior taxable years to which the regulations under section 987 apply, as determined under § 1.987–4(c), and by treating the separating QBU as having separated immediately prior to the beginning of the taxable year of separation. A separated QBU's share of the separating QBU's net accumulated unrecognized section 987 gain or loss for all such prior taxable years is determined by apportioning the separating QBU's net accumulated unrecognized section 987 gain or loss for all such prior taxable years 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 after the separation. For purposes of determining the owner functional currency net value of the separated QBUs on the last day of the taxable year preceding the taxable year of separation under § 1.987–5(d)(1)(B) and (e), the balance sheets of the separated QBUs on that day will be deemed to reflect the assets and liabilities reflected on the balance sheet of the separating QBU on that day, apportioned between the separated QBUs in a reasonable manner that takes into account the assets and liabilities reflected on the balance sheets of the separated QBUs immediately after the separation.

(3) *Examples.* The following examples illustrate the rules of paragraphs (f)(1) and (2) of this section.

Example 1. Combination of two section 987 QBUs that have the same owner. (i) *Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in France that constitutes a section 987 QBU (French QBU) that has the euro as its functional currency. French QBU has a net accumulated unrecognized section 987 loss from all prior taxable years to which the regulations under section 987 apply of $100. DC1 also owns Entity B, a DE. Entity B conducts a business in Germany that constitutes a section 987 QBU (German QBU) that has the euro as its functional currency. German QBU has a net accumulated unrecognized section 987 gain from all prior taxable years to which the regulations under section 987 apply of $110. During the taxable year, Entity A and Entity B merge under local law. As a result, the books and records of French QBU and German QBU are combined into a new single set of books and records. The combined entity has the euro as its functional currency.

(ii) *Analysis.* Pursuant to § 1.987–2T(c)(9)(i), French QBU and German QBU are combining QBUs, and their combination does not give rise to a transfer that is taken into account in determining the amount of a remittance (as defined in § 1.987–5(c)). For purposes of computing net unrecognized section 987 gain or loss under § 1.987–4 for the year of the combination, the combination is deemed to have occurred on the last day of the owner's prior taxable year, such that the owner functional currency net value of the combined section 987 QBU at the end of that taxable year described under § 1.987–4(d)(1)(B) takes into account items reflected on the balance sheets of both French QBU and German QBU at that time. Additionally, any transactions between French QBU and German QBU occurring during the year of the merger will not result in transfers to or from a section 987 QBU. Pursuant to paragraph (f)(1) of this section, the combined QBU will have a net accumulated unrecognized section 987 gain from all prior taxable years of $10 (the $100 loss from French QBU plus the $110 gain from German QBU).

Example 2. Separation of two section 987 QBUs that have the same owner. (i) *Facts.* DC1, a domestic corporation, owns Entity A, a DE. Entity A conducts a business in the Netherlands that constitutes a section 987 QBU (Dutch QBU) that has the euro as its functional currency. The business of Dutch QBU consists of manufacturing and selling bicycles and scooters and is recorded on a single set of books and records. On the last day of Year 1, the adjusted basis of the gross assets of Dutch QBU is €1,000. In Year 2, the net accumulated unrecognized section 987 loss of Dutch QBU from all prior taxable years is $200. During Year 2, Entity A separates the bicycle and scooter business such that each business begins to have its own books and records and to meet the definition of a section 987 QBU under § 1.987–1(b)(2) (hereafter, ''bicycle QBU'' and ''scooter QBU''). There are no transfers between DC1 and Dutch QBU before the separation. After the separation, the aggregate adjusted basis of bicycle QBU's assets is €600 and the aggregate adjusted basis of scooter QBU's assets is €400. Each section 987 QBU continues to have the euro as its functional currency.

(ii) *Analysis.* Pursuant to § 1.987–2T(c)(9)(iii), bicycle QBU and scooter QBU are separated QBUs, and the separation of Dutch QBU, a separating QBU, does not give rise to a transfer taken into account in determining the amount of a remittance (as defined in § 1.987–5(c)). For purposes of computing net unrecognized section 987 gain or loss under § 1.987–4 for Year 2, the separation will be deemed to have occurred on the last day of the owner's prior taxable year, Year 1. Pursuant to paragraph (f)(2) of this section, bicycle QBU will have a net accumulated unrecognized section 987 loss of $120 (€600/€1,000 × $200), and scooter QBU will have a net accumulated unrecognized section 987 loss of $80 (€400/€1,000 × $200).

(g) [Reserved]. For further guidance, see § 1.987–4(g).

(h) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(i) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 11.** Section 1.987–6 is amended by adding paragraph (b)(4) to read as follows:

§ 1.987–6 Character and source of section 987 gain or loss.

* * * * *

(b) * * *

(4) [Reserved]. For further guidance, see § 1.987–6T(b)(4).

* * * * *

■ **Par. 12.** Section 1.987–6T is added to read as follows:

§ 1.987–6T Character and source of section 987 gain or loss (temporary)

(a) through (b)(3) [Reserved]. For further guidance, see § 1.987–6(a) through (b)(3).

(4) *Source of section 987 gain or loss with respect to a dollar QBU.* The source of section 987 gain or loss with respect to a dollar QBU (as defined in § 1.987–1T(b)(6)(i)) for which the CFC owner has elected under § 1.987–1T(b)(6)(iii) to apply section 987 is determined by reference to the residence of the CFC owner. This paragraph (b)(4) applies to any CFC that has made the election under § 1.987–1T(b)(6)(iii), including a CFC described in § 1.987–1(b)(1)(ii).

(c) [Reserved]. For further guidance, see § 1.987–6(c).

(d) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(e) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 13.** Section 1.987–7 is amended by adding paragraph (b) to read as follows:

§ 1.987–7 Section 987 aggregate partnerships.

* * * * *

(b) [Reserved]. For further guidance, see § 1.987–7T(b).

* * * * *

■ **Par. 14.** Section 1.987–7T is added to read as follows:

§ 1.987–7T Section 987 aggregate partnerships (temporary).

(a) [Reserved]. For further guidance, see § 1.987–7(a).

(b) *Liquidation value percentage methodology*—(1) *In general.* In any taxable year, a partner's share of each asset, including its basis in each asset, and the amount of each liability reflected under § 1.987–2(b) on the books and records of an eligible QBU owned indirectly through a section 987 aggregate partnership is proportional to the partner's liquidation value percentage with respect to the aggregate partnership for that taxable year, as determined under paragraph (b)(2) of this section.

(2) *Liquidation value percentage*—(i) *In general.* For purposes of this paragraph (b), a partner's liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all of the partners' interests in the partnership. The liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752–7), paid an unrelated third party to assume all of its § 1.752–7 liabilities in a fully taxable transaction, and then liquidated.

(ii) *Determination date.*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, the determination date is the date of the most recent event described in § 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (a revaluation event), irrespective of whether the capital accounts of the partners are adjusted under § 1.704–1(b)(2)(iv)(*f*), or, if there has been no revaluation event, the date of the formation of the partnership.

(B) *Allocations not in accordance with liquidation value percentage.* If a partnership agreement provides for the allocation of any item of income, gain, deduction, or loss from partnership property to a partner other than in accordance with the partner's liquidation value percentage, the determination date is the last day of the partner's taxable year, or, if the partner's section 987 QBU owned indirectly through a section 987 aggregate partnership terminates during the partner's taxable year, the date such section 987 QBU is terminated.

(3) *Example.* The following example illustrates the rule of this paragraph (b).

Example. (i) *Facts.* DC, a domestic corporation, owns all of the stock of FS, a controlled foreign corporation (as defined in section 957(a)) with the U.S. dollar as its functional currency. FS owns a capital and profits interest in FPRS, a foreign partnership. The remaining capital and profits interest in FPRS is owned by DC. FPRS is a section 987 aggregate partnership with the euro as its functional currency. The balance sheet of FPRS reflects one asset (Asset A) with a basis of €60x and a fair market value of €100x, another asset (Asset B) with a basis of €100x and a fair market value of €200x, and a liability (Liability) of €50x. At the end of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, of DC with respect to FPRS is 75 percent, and the liquidation value percentage of FS with respect to FPRS is 25 percent.

(ii) *Result.* Under § 1.987–1(b)(4), DC and FS are each treated as indirectly owning an eligible QBU with a balance sheet that reflects their respective shares of any assets and liabilities of FPRS. Under paragraph (b)(1) of this section, DC and FS's shares of FPRS's assets and liabilities are determined in accordance with DC and FS's respective liquidation value percentages. Accordingly, because DC has a liquidation value percentage of 75 percent with respect to FPRS, €75x of Asset A (with a €45x basis), €150x of Asset B (with a €75x basis), and

€37.50x of Liability will be attributed to the DC–FPRS QBU. Additionally, because FS has a liquidation value percentage of 25 percent with respect to FPRS, €25x of Asset A (with a €15x basis), €50x of Asset B (with a €25x basis), and €12.50x of Liability will be attributed to the FS–FPRS QBU.

(c) [Reserved]. For further guidance, see § 1.987–7(c).

(d) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(e) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 15.** Section 1.987–8 is amended by adding paragraph (d) to read as follows:

§ 1.987–8 Termination of a section 987 QBU.

* * * * *

(d) [Reserved]. For further guidance, see § 1.987–8T(d).

* * * * *

■ **Par. 16.** Section 1.987–8T is added to read as follows

§ 1.987–8T Termination of a section 987 QBU (temporary).

(a) through (c) [Reserved]. For further guidance, see § 1.987–8(a) through (c).

(d) *Annual deemed termination election.* A taxpayer, including a taxpayer described in § 1.987–1(b)(1)(ii) to which §§ 1.987–1 through 1.987–11 generally do not apply, may elect under this paragraph (d) to deem all of the section 987 QBUs of which it is an owner to terminate on the last day of each taxable year for which the election is in effect. See § 1.987–8(e) regarding the effect of such a deemed termination. The owner of a section 987 QBU that is deemed to terminate under this paragraph is treated as having transferred all of the assets and liabilities attributable to such section 987 QBU to a new section 987 QBU on the first day of the following taxable year.

(e) through (f) [Reserved]. For further guidance, see § 1.987–8(e) through (f).

(g) *Effective/applicability date.* This section applies to taxable years beginning on or after December 7, 2016.

(h) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 17.** Section 1.987–12 is added to read as follows:

§ 1.987–12 Deferral of section 987 gain or loss.

(a) through (h) [Reserved]. For further guidance, see § 1.987–12T(a) through (h).

■ **Par. 18.** Section 1.987–12T is added to read as follows:

§ 1.987–12T Deferral of section 987 gain or loss (temporary).

(a) *In general*—(1) *Overview.* This section provides rules that defer the recognition of section 987 gain or loss that, but for this section, would be recognized in connection with certain QBU terminations and certain other transactions involving partnerships. This paragraph (a) provides an overview of this section and describes the section's scope of application, including with respect to QBUs subject to section 987 but to which §§ 1.987–1 through 1.987–11 generally do not apply. Paragraph (b) of this section describes the extent to which section 987 gain or loss is recognized under § 1.987–5 or similar principles in the taxable year of a deferral event (as defined in paragraph (b)(2) of this section) with respect to a QBU. Paragraph (c) of this section describes the extent to which section 987 gain or loss that, as a result of paragraph (b), is not recognized under § 1.987–5 or similar principles is recognized upon the occurrence of subsequent events. Paragraph (d) of this section describes the extent to which section 987 loss is recognized under § 1.987–5 or similar principles in the taxable year of an outbound loss event (as defined in paragraph (d)(2) of this section) with respect to a QBU. Paragraph (e) of this section provides rules for determining the source and character of gains and losses that, as a result of this section, are not recognized under § 1.987–5 or similar principles in the taxable year of a deferral event or outbound loss event. Paragraph (f) of this section defines controlled group and qualified successor for purposes of this section. Paragraph (g) of this section provides an anti-abuse rule. Paragraph (h) of this section provides examples illustrating the rules described in this section.

(2) *Scope.* This section applies to any foreign currency gain or loss realized under section 987(3), including foreign currency gain or loss of an entity described in § 1.987–1(b)(1)(ii). References in this section to section 987 gain or loss refer to any foreign currency gain or loss realized under section 987(3), references to a section 987 QBU refer to any eligible QBU (as defined in § 1.987–1(b)(3)(i), but without regard to § 1.987–1(b)(3)(ii)) that is subject to section 987, and references to a section 987 aggregate partnership refer to any partnership for which the acquisition or disposition of a partnership interest could give rise to foreign currency gain or loss realized under section 987(3). Additionally, references to recognition of section 987 gain or loss under § 1.987–5 encompass any determination and recognition of gain or loss under section 987(3) that would occur but for this section. Accordingly, the principles of this section apply to a QBU subject to section 987 regardless of whether the QBU otherwise is subject to §§ 1.987–1 through 1.987–11. An owner of a QBU that is not subject to § 1.987–5 must adapt the rules set forth in this section as necessary to recognize section 987 gains or losses that are subject to this section consistent with the principles of this section.

(3) *Exceptions*—(i) *Annual deemed termination elections.* This section does not apply to section 987 gain or loss of a section 987 QBU with respect to which the annual deemed termination election described in § 1.987–8T(d) is in effect.

(ii) *De minimis exception.* This section does not apply to a section 987 QBU for a taxable year if the net unrecognized section 987 gain or loss of the section 987 QBU that, as a result of this section, would not be recognized under § 1.987–5 in the taxable year does not exceed $5 million.

(b) *Gain and loss recognition in connection with a deferral event*—(1) *In general.* Notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which a deferral event occurs (a deferral QBU) includes in taxable income section 987 gain or loss in connection with the deferral event only to the extent provided in paragraphs (b)(3) and (c) of this section. However, if the deferral event also constitutes an outbound loss event described in paragraph (d) of this section, the amount of loss recognized by the owner may be further limited under that paragraph.

(2) *Deferral event*—(i) *In general.* A deferral event with respect to a section 987 QBU means any transaction or series of transactions that satisfy the conditions described in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section.

(ii) *Transactions.* The transaction or series of transactions include either:

(A) A termination of the section 987 QBU other than any of the following terminations: a termination described in § 1.987–8(b)(3), a termination described in § 1.987–8(c), or a termination described solely in § 1.987–8(b)(1); or

(B) A disposition of part of an interest in a section 987 aggregate partnership or DE through which the section 987 QBU is owned or any contribution by another person to such a partnership or DE of assets that, immediately after the contribution, are not considered to be included on the books and records of an eligible QBU, provided that the contribution gives rise to a deemed transfer from the section 987 QBU to the owner.

(iii) *Assets on books of successor QBU.* Immediately after the transaction or series of transactions, assets of the section 987 QBU are reflected on the books and records of a successor QBU (as defined in paragraph (b)(4) of this section).

(3) *Gain or loss recognized under § 1.987–5 in the taxable year of a deferral event.* In the taxable year of a deferral event with respect to a deferral QBU, the owner of the deferral QBU recognizes section 987 gain or loss as determined under § 1.987–5, except that, solely for purposes of applying § 1.987–5, all assets and liabilities of the deferral QBU that, immediately after the deferral event, are reflected on the books and records of a successor QBU are treated as not having been transferred and therefore as remaining on the books and records of the deferral QBU notwithstanding the deferral event.

(4) *Successor QBU.* For purposes of this section, a section 987 QBU (potential successor QBU) is a successor QBU with respect to a section 987 QBU referred to in paragraph (b)(2)(ii) of this section if, immediately after the transaction or series of transactions described in that paragraph, the potential successor QBU satisfies all of the conditions described in paragraphs (b)(4)(i) through (b)(4)(iii) of this section.

(i) The books and records of the potential successor QBU reflect assets that, immediately before the transaction or series of transactions described in paragraph (b)(2)(ii) of this section, were reflected on the books and records of the section 987 QBU referred to in that paragraph.

(ii) The owner of the potential successor QBU and the owner of the section 987 QBU referred to in paragraph (b)(2)(ii) of this section immediately before the transaction or series of transactions described in that paragraph are members of the same controlled group.

(iii) In the case of a section 987 QBU referred to in paragraph (b)(2)(ii)(A) of this section, if the owner of the section 987 QBU immediately before the transaction or series of transactions described in that paragraph was a U.S. person, the potential successor QBU is owned by a U.S. person.

(c) *Recognition of deferred section 987 gain or loss in the taxable year of a deferral event and in subsequent taxable years*—(1) *In general*—(i) *Deferred section 987 gain or loss.* A deferral QBU owner (as defined in paragraph (c)(1)(ii) of this section) recognizes section 987 gain or loss attributable to the deferral QBU that, as a result of paragraph (b) of this section, is not recognized in the taxable year of the deferral event under § 1.987–5 (deferred section 987 gain or loss) in the taxable year of the deferral event and in subsequent taxable years as provided in paragraphs (c)(2) through (4) of this section.

(ii) *Deferral QBU owner.* For purposes of this paragraph (c), a deferral QBU owner means, with respect to a deferral QBU, the owner of the deferral QBU immediately before the deferral event, or the owner's qualified successor.

(2) *Recognition upon a subsequent remittance*—(i) *In general.* Except as provided in paragraph (c)(3) of this section, a deferral QBU owner recognizes deferred section 987 gain or loss in the taxable year of the deferral event and in subsequent taxable years upon a remittance from a successor QBU to the owner of the successor QBU (successor QBU owner) in the amount described in paragraph (c)(2)(ii) of this section.

(ii) *Amount.* The amount of deferred section 987 gain or loss that is recognized pursuant to this paragraph (c)(2) in a taxable year of the deferral QBU owner is the outstanding deferred section 987 gain or loss (that is, the amount of deferred section 987 gain or loss not previously recognized) multiplied by the remittance proportion of the successor QBU owner with respect to the successor QBU for the taxable year ending with or within the taxable year of the deferral QBU owner, as determined under § 1.987–5(b) (and, to the extent relevant, paragraphs (b) and (c)(2)(iii) of this section) without regard to any election under § 1.987–8T(d). For purposes of computing this remittance proportion, multiple successor QBUs of the same deferral QBU are treated as a single successor QBU.

(iii) *Deemed remittance when a successor QBU ceases to be owned by a member of the deferral QBU owner's controlled group.* For purposes of this paragraph (c)(2), in a taxable year of the deferral QBU owner in which a successor QBU ceases to be owned by a member of a controlled group that includes the deferral QBU owner, the successor QBU owner is treated as having a remittance proportion of 1. Accordingly, if there is only one successor QBU with respect to a deferral QBU and that successor QBU ceases to be owned by a member of the controlled group that includes the deferral QBU owner, all outstanding deferred section 987 gain or loss with respect to that deferral QBU will be recognized. This paragraph (c)(2)(iii) does not affect the application of §§ 1.987–1 through 1.987–11 to the successor QBU owner with respect to its ownership of the successor QBU.

(3) *Recognition of deferred section 987 loss in certain outbound successor QBU terminations.* Notwithstanding paragraph (c)(2) of this section, if assets of the successor QBU (transferred assets) are transferred (or deemed transferred) in a transaction that would constitute an outbound loss event if the successor QBU had a net accumulated section 987 loss at the time of the exchange, then the deferral QBU owner recognizes outstanding deferred section 987 loss, if any, to the extent it would recognize loss under paragraph (d)(1) of this section if (i) the deferral QBU owner owned the successor QBU, (ii) the deferral QBU owner had net unrecognized section 987 loss with respect to the successor QBU equal to its outstanding deferred section 987 loss with respect to the deferral QBU, and (iii) the transferred assets were transferred (or deemed transferred) in an outbound loss event. Any outstanding deferred section 987 loss with respect to the deferral QBU that is not recognized as a result of the preceding sentence is recognized by the deferral QBU owner in the first taxable year in which the deferral QBU owner (including any qualified successor) ceases to be a member of a controlled group that includes the acquirer of the transferred assets or any qualified successor of such acquirer.

(4) *Special rules regarding successor QBUs*—(i) *Successor QBU with respect to a deferral QBU that is a successor QBU.* If a section 987 QBU is a successor QBU with respect to a deferral QBU that is a successor QBU with respect to another deferral QBU, the first-mentioned section 987 QBU is considered a successor QBU with respect to the second-mentioned deferral QBU. For example, if QBU A is a successor QBU with respect to QBU B, and QBU B is a successor QBU with respect to QBU C, then QBU A is a successor QBU with respect to QBU C.

(ii) *Separation of a successor QBU.* If a successor QBU with respect to a deferral QBU separates into two or more separated QBUs (as defined in § 1.987–2T(c)(9)(iii)), each separated QBU is considered a successor QBU with respect to the deferral QBU.

(iii) *Combination of a successor QBU.* If a successor QBU with respect to a deferral QBU combines with another section 987 QBU of the same owner, resulting in a combined QBU (as defined in § 1.987–2T(c)(9)(i)), the combined QBU is considered a successor QBU with respect to the deferral QBU.

(d) *Loss recognition upon an outbound loss event*—(1) *In general.* Notwithstanding § 1.987–5, the owner of a section 987 QBU with respect to which an outbound loss event occurs (an outbound loss QBU) includes in taxable income in the taxable year of an outbound loss event section 987 loss with respect to that section 987 QBU only to the extent provided in paragraph (d)(3) of this section.

(2) *Outbound loss event.* An outbound loss event means, with respect to a section 987 QBU:

(i) Any termination of the section 987 QBU in connection with a transfer by a U.S. person of assets of the section 987 QBU to a foreign person that is a member of the same controlled group as the U.S. transferor immediately before the transaction or, if the transferee did not exist immediately before the transaction, immediately after the transaction (related foreign person), provided that the termination would result in the recognition of section 987 loss with respect to the section 987 QBU under § 1.987–5 and paragraph (b) of this section but for this paragraph (d);

(ii) Any transfer by a U.S. person of part of an interest in a section 987 aggregate partnership or DE through which the U.S. person owns the section 987 QBU to a related foreign person that has the same functional currency as the section 987 QBU, or any contribution by such a related foreign person to such a partnership or DE of assets that, immediately after the contribution, are not considered to be included on the books and records of an eligible QBU, provided that the transfer would result in the recognition of section 987 loss with respect to the section 987 QBU under § 1.987–5 and paragraph (b) of this section but for this paragraph (d).

(3) *Loss recognized upon an outbound loss event.* In the taxable year of an outbound loss event with respect to an outbound loss QBU, the owner of the outbound loss QBU recognizes section 987 loss as determined under § 1.987–5 and paragraphs (b) and (c) of this section, except that, solely for purposes of applying § 1.987–5, the following assets and liabilities of the outbound loss QBU are treated as not having been transferred and therefore as remaining on the books and records of the outbound loss QBU notwithstanding the outbound loss event:

(i) In the case of an outbound loss event described in paragraph (d)(2)(i) of this section, assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the related foreign person described in that paragraph or of a section 987 QBU owned by such related foreign person; and

(ii) In the case of an outbound loss event described in paragraph (d)(2)(ii) of this section, assets and liabilities that, immediately after the outbound loss event, are reflected on the books and records of the eligible QBU from which the assets and liabilities of the outbound loss QBU are allocated and not on the books and records of a section 987 QBU.

(4) *Adjustment of basis of stock received in certain nonrecognition transactions.* If an outbound loss event results from the transfer of assets of the outbound loss QBU in a transaction described in section 351 or section 361, the basis of the stock that is received in the transaction is increased by an amount equal to the section 987 loss that, as a result of this paragraph (d), is not recognized with respect to the outbound loss QBU in the taxable year of the outbound loss event (outbound section 987 loss).

(5) *Recognition of outbound section 987 loss that is not converted into stock basis.* Outbound section 987 loss attributable to an outbound loss event that is not described in paragraph (d)(4) of this section is recognized by the owner of the outbound loss QBU in the first taxable 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 referred to in paragraph (d)(2)(i) or (ii) of this section, or any qualified successor of such person.

(e) *Source and character*—(1) *Deferred section 987 gain or loss and certain outbound section 987 loss.* The source and character of deferred section 987 gain or loss recognized pursuant to paragraph (c) of this section, and of outbound section 987 loss recognized pursuant to paragraph (d)(5) of this section, is determined under § 1.987–6 as if such deferred section 987 gain or loss were recognized pursuant to § 1.987–5 without regard to this section on the date of the related deferral event or outbound loss event.

(2) *Outbound section 987 loss reflected in stock basis.* If loss is recognized on the sale or exchange of stock described in paragraph (d)(4) of this section within two years of the outbound loss event described in that paragraph, then, to the extent of the outbound section 987 loss, the source and character of the loss recognized on the sale or exchange is determined under § 1.987–6 as if such loss were section 987 loss recognized pursuant to § 1.987–5 without regard to this section on the date of the outbound loss event.

(f) *Definitions*—(1) *Controlled group.* For purposes of this section, a controlled group means all persons with the relationships to each other specified in sections 267(b) or 707(b).

(2) *Qualified successor.* For purposes of this section, a qualified successor with respect to a corporation (transferor corporation) means another corporation (acquiring corporation) that acquires the assets of the transferor corporation in a transaction described in section 381(a), but only if (A) the acquiring corporation is a domestic corporation and the transferor corporation was a domestic corporation, or (B) the acquiring corporation is a controlled foreign corporation (as defined in section 957(a)) (CFC) and the transferor corporation was a CFC. A qualified successor of a corporation includes the qualified successor of a qualified successor of the corporation.

(g) *Anti-abuse.* No section 987 loss is recognized under § 1.987–5 or this section in connection with a transaction or series of transactions that are undertaken with a principal purpose of avoiding the purposes of this section.

(h) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, DC1 is a domestic corporation that owns all of the stock of DC2, which is also a domestic corporation, and CFC1 and CFC2 are CFCs. In addition, DC1, DC2, CFC1, and CFC2 are members of a controlled group as defined in paragraph (f)(1) of this section, and the de minimis rule of paragraph (a)(3)(ii) of this section is not applicable. Finally, except as otherwise provided, Business A is a section 987 QBU with the euro as its functional currency, there are no transfers between Business A and its owner, and Business A's assets are not depreciable or amortizable.

Example 1. Contribution of a section 987 QBU to a member of the controlled group. (i) *Facts.* DC1 owns all of the interests in Business A. The balance sheet of Business A reflects assets with an aggregate adjusted basis of €1,000x and no liabilities. DC1 contributes €900x of Business A's assets to DC2 in an exchange to which section 351 applies. Immediately after the contribution, the remaining €100x of Business A's assets are no longer reflected on the books and records of a section 987 QBU. DC2, which has the U.S. dollar as its functional currency, uses the former Business A assets in a business (Business B) that constitutes a section 987 QBU. At the time of the contribution, Business A has net accumulated unrecognized section 987 gain of $100x.

(ii) *Analysis.* (A) Under § 1.987–2(c)(2)(ii), DC1's contribution of €900x of Business A's assets to DC2 is treated as a transfer of all of the assets of Business A to DC1, immediately followed by DC1's contribution of €900x of Business A's assets to DC2. The contribution of Business A's assets is a deferral event within the meaning of paragraph (b)(2) of this section because: (1) The transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, resulting in a termination of Business A under § 1.987–8(b)(2); and (2) immediately after the transaction, assets of Business A are reflected on the books and records of Business B, a section 987 QBU owned by a member of DC1's controlled group and a successor QBU within the meaning of paragraph (b)(4) of this section. Accordingly, Business A is a deferral QBU within the meaning of paragraph (b)(1) of this section, and DC1 is a deferral QBU owner of Business A within the meaning of paragraph (c)(1)(ii) of this section.

(B) Under paragraph (b)(3) of this section, DC1's taxable income in the taxable year of the deferral event includes DC1's section 987 gain or loss determined with respect to Business A under § 1.987–5, except that, for purposes of applying § 1.987–5, all assets and liabilities of Business A that are reflected on the books and records of Business B immediately after Business A's termination are treated as not having been transferred and therefore as though they remained on Business A's books and records (notwithstanding the deemed transfer of those assets under § 1.987–8(e)). Accordingly, in the taxable year of the deferral event, DC1 is treated as making a remittance of €100x, corresponding to the assets of Business A that are no longer reflected on the books and records of a section 987 QBU, and is treated as having a remittance proportion with respect to Business A of 0.1, determined by dividing the €100x remittance by the sum of the remittance and the €900x aggregate adjusted basis of the gross assets deemed to remain on Business A's books at the end of the year. Thus, DC1 recognizes $10x of section 987 gain in the taxable year of the deferral event. DC1's deferred section 987 gain equals $90x, which is the amount of section 987 gain that, but for the application of paragraph (b) of this section, DC1 would have recognized under § 1.987–5 ($100x), less the amount of section 987 gain recognized by DC1 under § 1.987–5 and this section ($10x).

Example 2. Election to be classified as a corporation. (i) *Facts.* DC1 owns all of the interests in Entity A, a DE. Entity A conducts Business A, which has net accumulated unrecognized section 987 gain of $500x. Entity A elects to be classified as a corporation under § 301.7701–3(a). As a result of the election and pursuant to § 301.7701–3(g)(1)(iv), DC1 is treated as contributing all of the assets and liabilities of Business A to newly-formed CFC1, which has the euro as its functional currency. Immediately after the contribution, the assets and liabilities of Business A are reflected on CFC1's balance sheet.

(ii) *Analysis.* Under § 1.987–2(c)(2)(ii), DC1's contribution of all of the assets and liabilities of Business A to CFC1 is treated as a transfer of all of the assets and liabilities of Business A to DC1, followed immediately by DC1's contribution of those assets and liabilities to CFC1. Because the deemed transfer from Business A to DC1 is a transfer of substantially all of Business A's assets to DC1, the Business A QBU terminates under § 1.987–8(b)(2). The contribution of Business A's assets is not a deferral event within the meaning of paragraph (b)(2) of this section because, immediately after the transaction, no assets of Business A are reflected on the books and records of a successor QBU within the meaning of paragraph (b)(4) of this section due to the fact that the assets of Business A are not reflected on a section 987 QBU immediately after the termination as well as the fact that the requirement of paragraph (b)(4)(iii) of this section is not met. Accordingly, DC1 recognizes section 987 gain with respect to Business A under § 1.987–5 without regard to this section. Because the requirement of paragraph (b)(4)(iii) of this section is not met, the result would be the same even if the assets of Business A were transferred in a section 351 exchange to an existing foreign corporation that had a different functional currency than Business A.

Example 3. Outbound loss event. (i) *Facts.* The facts are the same as in *Example 2,* except that Business A has net accumulated unrecognized section 987 loss of $500x rather than net accumulated unrecognized section 987 gain of $500x.

(ii) *Analysis.* (A) The analysis of the transactions under §§ 1.987–2(c)(2)(ii), 1.987–8(b)(2), and paragraph (b) of this section is the same as in *Example 2.* However, the termination of Business A as a result of the transfer of the assets of Business A by a U.S. person (DC1) to a foreign person (CFC1) that is a member of DC1's controlled group is an outbound loss event described in paragraph (d)(2) of this section.

(B) Under paragraphs (d)(1) and (d)(3) of this section, in the taxable year of the outbound loss event, DC1 includes in taxable income section 987 loss recognized with respect to Business A as determined under § 1.987–5, except that, for purposes of applying § 1.987–5, all assets and liabilities of Business A that are reflected on the books and records of CFC1, a related foreign person described in paragraph (d)(2) of this section, are treated as not having been transferred. Accordingly, DC1's remittance proportion with respect to Business A is 0, and DC1 recognizes no section 987 loss with respect to Business A. DC1's outbound section 987 loss is $500x, which is the amount of section 987 loss that DC1 would have recognized under § 1.987–5 ($500x) without regard to paragraph (d) of this section, less the amount of section 987 loss recognized by DC1 under paragraph (d)(3) of this section ($0). Under paragraph (d)(4) of this section, DC1 must increase its basis in its CFC1 shares by the amount of the outbound section 987 loss ($500x).

Example 4. Conversion of a DE to a partnership. (i) *Facts.* DC1 owns all of the interests in Entity A, a DE that conducts Business A. On the last day of Year 1, DC1 sells 50 percent of its interest in Entity A to DC2 (the Entity A sale).

(ii) *Analysis.* (A) For Federal income tax purposes, Entity A is converted to a partnership when DC2 purchases the 50 percent interest in Entity A. DC2's purchase is treated as the purchase of 50 percent of the assets of Entity A (that is, the assets of Business A), which, prior to the purchase, were treated as held directly by DC1 for Federal income tax purposes. Immediately after DC2's deemed purchase of 50 percent of Business A assets, DC1 and DC2 are treated as contributing their respective interests in Business A assets to a partnership. See Rev. Rul. 99–5 (1999–1 CB 434) (situation 1). These deemed transactions are not taken into account for purposes of this section, but the Entity A sale and resulting existence of a partnership have consequences under section 987 and this section, as described in paragraphs (ii)(B) through (D) of this *Example 4.*

(B) Immediately after the Entity A sale, Entity A is a section 987 aggregate partnership within the meaning of § 1.987–1(b)(5) because DC1 and DC2 own all the interests in partnership capital and profits, DC1 and DC2 are related within the meaning of section 267(b), and the partnership has an eligible QBU (Business A) that would be a section 987 QBU with respect to a partner if owned by the partner directly. As a result of the Entity A sale, 50 percent of the assets and liabilities of Business A ceased to be reflected on the books and records of DC1's Business A section 987 QBU. As a result, such assets and liabilities are treated as if they were transferred from DC1's Business A section 987 QBU to DC1. Additionally, following DC2's acquisition of 50 percent of the interest in Entity A, DC2 is allocated 50 percent of the assets and liabilities of Business A under §§ 1.987–2(b), 1.987–7(a), and 1.987–7T(b). Because DC2 and Business A have different functional currencies, DC2's portion of the Business A assets and liabilities constitutes a section 987 QBU. Accordingly, 50 percent of the assets and liabilities of Business A are treated as transferred by DC2 to DC2's Business A section 987 QBU.

(C) The Entity A sale is a deferral event described in paragraph (b)(2) of this section because: (1) The sale constitutes the disposition of part of an interest in a DE; and (2) immediately after the transaction, assets of DC1's Business A section 987 QBU are reflected on the books and records of DC1's Business A section 987 QBU and DC2's Business A section 987 QBU, each of which is a successor QBU with respect to DC1's Business A section 987 QBU within the meaning of paragraph (b)(4) of this section. Accordingly, DC1's Business A section 987 QBU is a deferral QBU within the meaning of paragraph (b)(1) of this section, and DC1 is a deferral QBU owner within the meaning of paragraph (c)(1)(ii) of this section. Under paragraph (b)(1) of this section, DC1 includes in taxable income section 987 gain or loss with respect to Business A in connection with the deferral event to the extent provided in paragraphs (b)(3) and (c) of this section.

(D) Under paragraph (b) of this section, in the taxable year of the Entity A sale, DC1 includes in taxable income section 987 gain or loss with respect to Business A as determined under § 1.987–5, except that, for purposes of applying § 1.987–5, all assets and liabilities of Business A that, immediately after the Entity A sale, are reflected on the books and records of successor QBUs are treated as though they were not transferred and therefore as remaining on the books and records of DC1's Business A section 987 QBU notwithstanding the Entity A sale. Accordingly, DC1's remittance amount under § 1.987–5 is $0, and DC1 recognizes no section 987 gain or loss with respect to Business A.

Example 5. Partial recognition of deferred gain or loss. (i) *Facts.* DC1 owns all of the interests in Entity A, a DE that conducts Business A in Country X. During Year 1, DC1 contributes all of its interests in Entity A to DC2 in an exchange to which section 351 applies. At the time of the contribution, Business A has net accumulated unrecognized section 987 gain of $100x. After the contribution, Entity A continues to conduct business in Country X (Business B). In Year 3, as a result of a net transfer of property from Business B to DC2, DC2's remittance proportion with respect to Business B, as determined under § 1.987–5, is 0.25.

(ii) *Analysis.* (A) For the reasons described in *Example 1,* the contribution of Entity A by DC1 to DC2 results in a termination of Business A and a deferral event with respect to Business A, a deferral QBU; DC1 is a deferral QBU owner within the meaning of paragraph (c)(1)(ii) of this section; Business B is a successor QBU with respect to Business A; DC2 is a successor QBU owner; and the $100x of net accumulated unrecognized section 987 gain with respect to Business A becomes deferred section 987 gain as a result of the deferral event.

(B) Under paragraph (c)(1) of this section, DC1 recognizes deferred section 987 gain with respect to Business A in accordance with paragraphs (c)(2) through (4) of this section. Under paragraph (c)(2)(i) of this section, DC1 recognizes deferred section 987 gain in Year 3 as a result of the remittance from Business B to DC2. Under paragraph (c)(2)(ii) of this section, the amount of deferred section 987 gain that DC1 recognizes is $25x, which is DC1's outstanding deferred section 987 gain or loss ($100x) with respect to Business A multiplied by the remittance proportion (0.25) of DC2 with respect to Business B for the taxable year as determined under § 1.987–5(b).

(i) *Coordination with fresh start transition method*—(1) *In general.* If a taxpayer is a deferral QBU owner, or is or was the owner of an outbound loss QBU, and the taxpayer is required under § 1.987–10(a) to apply the fresh start transition method described in § 1.987–10(b) to the deferral QBU or outbound loss QBU, or would have been so required if the taxpayer had owned the deferral QBU or outbound loss QBU on the transition date (as defined in § 1.987–11(c)), the adjustments described in paragraphs (i)(2) and (i)(3) of this section, as applicable, must be made on the transition date.

(2) *Adjustment to deferred section 987 gain or loss.* The amount of any outstanding deferred section 987 gain or loss of a deferral QBU owner with respect to a deferral QBU described in paragraph (i)(1) of this section must be adjusted to equal the amount of outstanding deferred section 987 gain or loss that the deferral QBU owner would have had with respect to the deferral QBU on the transition date if, immediately before the deferral event, the deferral QBU had transitioned to the method prescribed by §§ 1.987–1 through 1.987–10 pursuant to the fresh start transition method.

(3) *Adjustments in the case of an outbound loss event.* The basis of any stock described in paragraph (d)(4) of this section that was received in connection with the transfer (or deemed transfer) of assets of an outbound loss QBU described in paragraph (i)(1) of this section and that is held on the transition date must be adjusted to equal the basis that such stock would have had on the transition date if, immediately prior to the outbound loss event, the outbound loss QBU had transitioned to the method prescribed by §§ 1.987–1 through 1.987–10 pursuant to the fresh start transition method. If no such stock was received, the amount of any outbound section 987 loss with respect to the outbound loss QBU that may be recognized on or after the transition date pursuant to paragraph (d)(5) of this section must be adjusted to equal the amount of such loss that would be outstanding and that may be recognized pursuant to that paragraph if, immediately before the outbound loss event, the outbound loss QBU had transitioned to the method prescribed by §§ 1.987–1 through 1.987–10 pursuant to the fresh start transition method.

(j) *Effective/applicability date*—(1) *In general.* Except as described in paragraph (j)(2) of this section, this section applies to any deferral event or outbound loss event that occurs on or after January 6, 2017.

(2) *Exception.* This section applies to any deferral event or outbound loss event that occurs on or after December 7, 2016, if such deferral event or outbound loss event is undertaken with a principal purpose of recognizing section 987 loss.

(k) *Expiration date.* The applicability of this section expires December 6, 2019.

■ **Par. 19.** Section 1.988–0 is amended by revising the entry for § 1.988–2(b)(16) and adding an entry for § 1.988–2(i) to read as follows:

§ 1.988–0 Taxation of gain or loss from a section 988 transaction; Table of contents.

* * * * *

§ 1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(16) [Reserved].

* * * * *

(i) [Reserved].

■ **Par. 20.** Section 1.988–1 is amended by adding paragraph (a)(3) to read as follows:

§ 1.988–1 Certain definitions and special rules.

* * * * *

(a) * * *

(3) [Reserved]. For further guidance, see § 1.988–1T(a)(3).

* * * * *

■ **Par. 21.** Section 1.988–1T is added to read as follows:

§ 1.988–1T Certain definitions and special rules (temporary).

(a)(1) through (a)(2) [Reserved]. For further guidance, see § 1.988–1(a)(1) through (2).

(3) *Specified owner functional currency transactions of a section 987 QBU not treated as section 988 transactions.* Specified owner functional currency transactions, as defined in § 1.987–3T(b)(4)(ii), held by a section 987 QBU are not treated as section 988 transactions. Thus, no currency gain or loss shall be recognized by a section 987 QBU under section 988 with respect to such transactions.

(4) through (i) [Reserved]. For further guidance, see § 1.988–1(a)(4) through (i).

(j) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

■ **Par. 22.** Section 1.988–2 is amended by revising paragraph (b)(16) and adding paragraph (i) to read as follows:

§ 1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(16) [Reserved]. For further guidance, see § 1.988–2T(b)(16).

* * * * *

(i) [Reserved]. For further guidance, see § 1.988–2T(i).

■ **Par. 23.** Section 1.988–2T is added to read as follows:

§ 1.988–2T Recognition and computation of exchange gain or loss (temporary).

(a) through (b)(15) [Reserved]. For further guidance, see § 1.988–2(a) through (b)(15).

(16) *Deferral of loss on certain related-party debt instruments.*—(i) *Treatment of creditor.* For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see § 1.267(f)–1(e).

(ii) *Treatment of debtor*—(A) *In general.* Exchange loss realized under § 1.988–2(b)(4) or (b)(6) is deferred if—

(*1*) The loss is realized by a debtor with respect to a loan from a person that has a relationship to the debtor described in section 267(b) or section 707(b); and

(*2*) The transaction resulting in the realization of exchange loss has as a principal purpose the avoidance of Federal income tax.

(B) *Recognition of deferred loss.* Any exchange loss that is deferred under paragraph (b)(16)(ii)(A) of this section is deferred until the end of the term of the loan, determined immediately prior to the transaction.

(17) through (h) [Reserved]. For further guidance, see § 1.988–2(b)(17) through (h).

(i) *Special rules for section 988 transactions of a section 987 QBU.* For rules regarding section 988 transactions of a section 987 QBU, see § 1.987–3T(b)(4) for section 987 QBUs in general and § 1.987–1T(b)(6) for dollar QBUs.

(j) *Effective/applicability date.* Paragraph (b)(16) of this section applies to any exchange loss realized on or after December 7, 2016. Paragraph (i) of this section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then paragraph (i) of this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: November 14, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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