Bloomberg Tax

Tax Management
International Journal™

March 3, 2025

How to Decode §987 Transition Rules

*By Cory Perry and Wei Fan**
Grant Thornton

Grant Thornton practitioners analyze what companies should consider when transitioning to the new computation methodologies provided under the transition rules of the final §987 regulations.

The final regulations under §987 (T.D. 10016), released in December 2024, mark a significant milestone in the storied history of §987 of the Code. The statute has been around for over 35 years, but except for one false start, final regulations addressing the computational rules have never been applicable to taxpayers. This left taxpayers with the flexibility to apply any reasonable method in calculating §987, using a variety of options, including methodologies that had been previously proposed and subsequently withdrawn. Now that regulations have been finalized, the foreign exchange exposure pool ("FEEP") method appears to be the definitive approach for §987. However, the regulations include a number of elections that offer taxpayers simplification and help avoid some of the onerous challenges that come along with the FEEP method.

With a clear direction on the calculation, taxpayers must transition from the reasonable method that they have been applying, perhaps for decades, to either the FEEP method or the methodology resulting from one or more elections. Transitioning from the prior methodology to the final regulations is described in significant detail in Treas. Reg. §1.987-10. The regulations include a complicated web of rules addressing how to calculate the amount of pretransition gain or loss determined under the old system prior to the finalization of regulations, as well as what happens to that gain or loss under the new system that is now in effect.

The impact of these transition rules can be significant to taxpayers. With the globalization of business, as well as the strengthening dollar, many companies may have material losses in a variety of jurisdictions where they operate through foreign branches. Therefore, the importance of these regulations is significant as it may lead to changes in the amount of and ability to recognize available losses. In this article, we will discuss these transition rules, highlight some of the traps to look out for, and outline

* Cory Perry is a principal at Grant Thornton, Washington National Tax Office. Wei Fan is a director, Washington National Tax Office, San Diego, California.

what taxpayers should consider when transitioning to one of the new computation methodologies provided under the final regulations.

What Is the Purpose of §987?

Section 987 governs the tax treatment of foreign currency transactions by US taxpayers conducted through a separate branch, division or disregarded entity, when activities rise to the level of a trade or business and for which the taxpayer maintains separate books and records (a qualified business unit or a "QBU"). The section specifies how to account for foreign exchange gains and losses related to a QBU with a functional currency different from the US dollar. Generally speaking, the rules aim to address currency consequences arising from exchange rate differences between when a QBU earns income or receives a property contribution from its owner and when that income or property is subsequently remitted to its owner.

To illustrate the concept behind §987, consider the following example: A US taxpayer's QBU earns 100x in Year 1 when the exchange rate is $1:1x. In Year 2, the QBU transfers the 100x earnings to the US taxpayer, but the exchange rate has shifted to $1:2x. As a result, the taxpayer was subject to tax when the 100x earnings were worth $100 US dollars in Year 1. However, in Year 2, the taxpayer only received $50 US dollars due to the depreciation of foreign currency. This resulted in a $50 loss to the taxpayer. Section 987 and the regulations thereunder offer guidance on the determination of what §987 currency gain or loss is, how this amount is determined, and when such gain or loss is recognized.

Regulatory Background

The §987 regulatory history dates back to 1991, when the first proposed regulations (56 Fed. Reg. 48457) were issued. That version required tax owners to maintain an equity pool in the QBU's functional currency and a basis pool in the tax owner's functional currency. Section 987 gain or loss was determined by comparing these pools with the value of the remittance in the taxpayer's functional currency (translated at the spot rate on the date the remittance is made).

In 2000, the IRS issued Notice 2000-20, raising concerns about abusive transactions involving circular fund flows between a QBU and its tax owner that could inappropriately accelerate recognition of §987 loss under the 1991 proposed regulations. The notice sought comments and proposed netting property transfers during the year.

In 2006, the IRS withdrew the 1991 proposed regulations due to concerns about taxpayers managing §987 gains and losses through strategic remittances. The IRS introduced a new FEEP method in revised proposed regulations (71 FR 52876).

Final regulations were issued in 2016 (T.D. 9794), adopting the FEEP method with adjustments along with proposed and temporary rules addressing several matters, including §988 transactions, partnerships, and a new annual deemed termination election. Parts of the 2016 proposed regulations were finalized in 2019 (T.D. 9857).

In 2017, the Trump administration issued Executive Order 13789 directing the Treasury to review regulations issued since Jan. 1, 2016, for undue financial burdens or complexity. Subsequent deferral notices, including Notice 2022-34, delayed implementation of the 2016 and 2019 regulations following the Executive Order.

In 2023, in response to the Executive Order, the IRS proposed new regulations with simplification measures while retaining the basic approach and structure of the 2016 and 2019 final regulations. These proposed regulations were finalized in December 2024, largely preserving the prior regulatory framework while incorporating additional key simplification measures. It is possible that the new Trump administration could once again seek to suspend these rules, but until and unless such official regulatory action occurs, taxpayers should be preparing to comply with the final regulations as written.

Transition Rules

The final regulations largely adopt the new transition rules outlined in the 2023 proposed regulations, which would account for unrecognized §987 gain or loss accrued before the transition date. The transition rules generally apply to
an owner of a §987 QBU on the applicable transition date, and an owner of a terminating QBU on the termination date (Treas. Reg. §1.987-10(b)(1)).

A key concept of the final regulations is the term "§987 QBU." The transition rules apply to taxpayers only if a §987 QBU existed on the relevant dates. A §987 QBU is an eligible QBU that has a functional currency different from its owner (Treas. Reg. §1.987-1(b)(3)(i)). An eligible QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained (Treas. Reg. §1.989(a)-1(b)), and not subject to the US approximate separate transactions method rules (Treas. Reg. §1.987-1(b)(4)). The determination of a trade or business is based on all facts and circumstances (Treas. Reg. §1.989(a)-1(c)).

The identification of a §987 QBU is performed based on the applicable transition date which is the first day of the first taxable year to which the §987 regulations apply (Treas. Reg. §1.987-10(c)). For calendar year taxpayers, the transition date is generally January 1, 2025 (Treas. Reg. §1.987-15(a)).

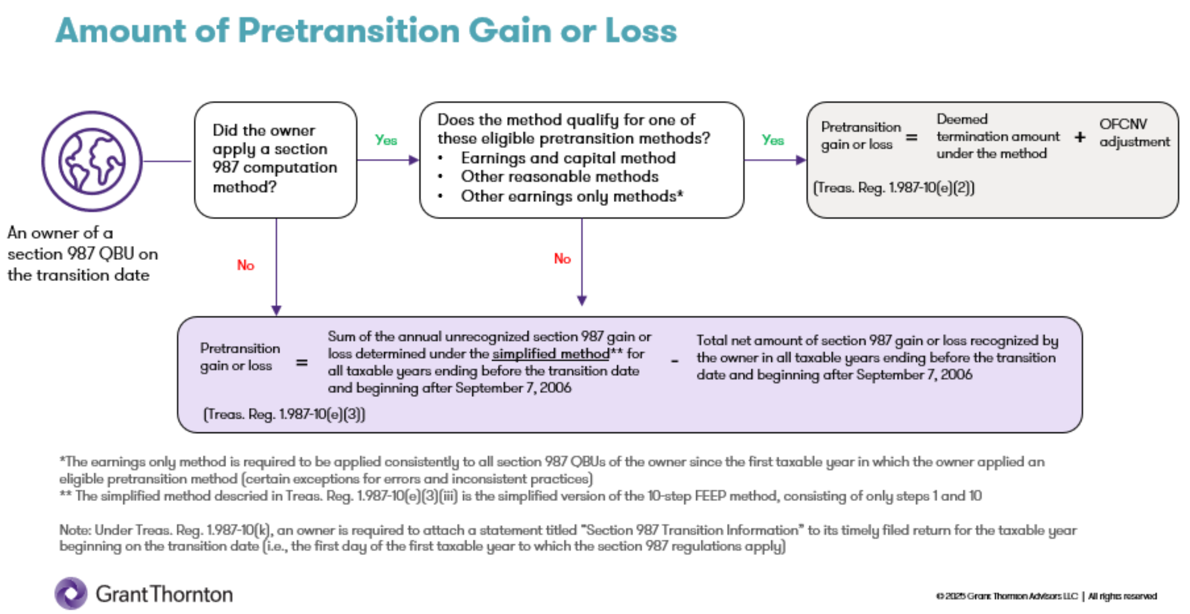
The final regulations also define a "terminating QBU", which generally refers to a §987 QBU that terminated after November 9, 2023, and before the taxable year in which the §987 regulations are generally applicable (Treas. Reg. §1.987-1(h)). With respect to a terminating QBU, the transition date is the day after the termination date (Treas. Reg. §1.987-10(c)(2)(i)).

The transition rules outlined in the final regulations prescribe distinct frameworks based on the taxpayer's application of §987 prior to the transition date. These rules further provide different treatments for pretransition gains or losses, contingent upon the elections made by the §987 owner.

Determining Pretransition Gain or Loss

The first step a taxpayer must undertake when transitioning to the final regulations is the determination of the amount of pretransition gain or loss. To do so, the taxpayer must identify its §987 QBUs, and then it must determine what computational methodology was historically applied to each of these QBUs.

As shown in the flowchart below, the key question in determining the appropriate method for calculating pretransition gain or loss is whether the taxpayer used a computation methodology that was an “eligible pretransition method” or an “ineligible” method.



Taxpayers that have applied an eligible pretransition §987 method on at least one tax return filed before Nov. 9, 2023, should use that method to compute a pretransition gain or loss amount equal to the amount of §987 gain or loss that it would have recognized if the QBU terminated on the day before the transition date (the “deemed termination amount”) (Treas. Reg. §1.987-10(e)(2)). The deemed termination amount is further adjusted by the owner functional currency net value adjustment (the “OFCNV adjustments”), generally calculated as the difference between:

- the basis of the assets, reduced by the amount of liabilities, that are attributable to the §987 QBU on the day before the transition date, translated into the owner’s functional currency at the transition exchange rate, which is generally the spot rate applicable to the day before the transition date (Treas. Reg. §1.987-10(d)(3)(i)), and
- the same amount translated at the pretransition translation rate, which is the rate that would be used under the eligible pretransition method to determine the basis of an asset or the amount of a liability in the hands of the owner of a §987 QBU if the §987 QBU transferred all of its assets and liabilities to the owner on the day before the transition date (Treas. Reg. §1.987-10(e)(2)(i)(C); Treas. Reg. §1.987-10(e)(2)(i)(C)).

Taxpayers that did not apply an eligible pretransition method would be required to determine pretransition gain or loss by applying a simplified version of the FEEP computation to determine unrecognized §987 gain or loss (Treas. Reg. §1.987-10(e)(3)).

Eligible Pretransition Method Rules

To qualify for an eligible method, a §987 QBU owner is required to apply one of the following three methods before the transition date (Treas. Reg. §1.987-10(e)(4)):

- Earnings and Capital Method — Under this method, §987 gain or loss is required to be determined and recognized with respect to both the earnings of the §987 QBU and capital contributed to the §987 QBU (Treas. Reg. §1.987-10(e)(4)(i)). The regulations explicitly list the method prescribed in the 1991 proposed regulations as an earnings and capital method (*Id*.).
- Other Reasonable Methods — This method includes any reasonable method which produces the same total amount of income over the life of the owner as an earnings and capital method (Treas. Reg. §1.987-10(e)(4)(ii)).
- Earnings only methods (i.e., methods that take into account earnings but not capital and that would not fall under the methods above), but only if (1) the method was first applied by the owner on a return filed before Nov. 9, 2023; (2) the method was consistently applied to all §987 QBUs of the owner since the first taxable year in which the owner applied the pretransition method; and (3) the owner otherwise applied §987 in a reasonable manner (Treas. Reg. §1.987-10(e)(4)(iii)).

The regulations explicitly point out that a method under which the owner of a §987 QBU defers the recognition of §987 gain or loss until the §987 QBU is terminated, sold, or liquidated is not a reasonable method and therefore not an eligible method (Treas. Reg. §1.987-10(e)(4)(vi)).

An owner is treated as applying an eligible pretransition method with respect to a §987 QBU only if it applied an eligible pretransition method with respect to the QBU on a return filed before November 9, 2023 (Treas. Reg. §1.987-10(e)(4)). In the preamble to the final regulations, the IRS clarifies that a taxpayer that first adopted a reasonable method in the first taxable year after the TCJA was enacted would be treated as applying an eligible pretransition method, but a method adopted after November 9, 2023, would not qualify.

In addition, the language of the final regulations refers to "a §987 QBU" or "the §987 QBU", indicating that the QBU itself must have applied the §987 method on a return. In other words, this is a QBU-by-QBU test. In practice, taxpayers may have applied §987 only to the QBUs that had remittances in prior years, while other QBUs, for which §987 was not considered, may be deemed to have applied an ineligible method.

Error and consistent practice

It is not uncommon for taxpayers to have made some errors when applying complicated §987 rules. The final regulations clarify that an owner is considered to have applied an eligible pre-transition method with respect to a QBU, even if:

- errors were made in the application of the method, or
- the method was not applied to every taxable year since the QBU's inception (Treas. Reg. §1.987-10(e)(4)(iv)).

The pretransition gain or loss is determined as though the eligible pretransition method was applied without error since the §987 QBU's inception (*Id*.). Thus, as clarified in the preamble, if a taxpayer made an error in applying its method for a prior year, the deemed termination amount is equal to the amount of §987 gain or loss the taxpayer would have recognized on termination if it had not made the error and its §987 QBU terminated on the day before the transition date.

However, if a taxpayer applied certain consistent practices (e.g., a reasonable convention) when applying §987 before the transition date, this practice may not be treated as an error in certain circumstances (Treas. Reg. §1.987-10(e)(4)(v)). Thus, unlike a taxpayer that made an error in applying its eligible pretransition method, a taxpayer that used a reasonable convention would not be required to recompute pretransition gain or loss without regard to the convention (Treas. Reg. §1.987-10(e)(4)(v)(B)(1)). The regulations list the use of a yearly average exchange rate rather than the applicable spot rate to translate frequently recurring transfers as an example of the reasonable convention practice (*Id*.).

Similarly, if a taxpayer had a consistent practice under which it did not account for certain disregarded transactions in determining the amount of a remittance, this practice is not treated as an error if the owner otherwise accounts for the disregarded transfers in a reasonable manner (Treas. Reg. §1.987-10(e)(4)(v)(B)(2)).

Ineligible Method Computation

If a §987 QBU owner has not applied §987 rules to a §987 QBU or the method applied does not qualify for an eligible pretransition method, the owner will need to recompute the gain or loss using a simplified method (Treas. Reg. § 1.987-10(e)(3)). The simplified method requires the taxpayer to sum the annual unrecognized §987 gain or loss determined under the method for all taxable years ending before the transition date and beginning after September 7, 2006 (Treas. Reg. §1.987-10(e)(3)(ii)(A)). Once determined, the taxpayer must subtract the total amount of §987 gain or loss recognized by the owner in all taxable years ending before the transition date and beginning after September 7, 2006 (Treas. Reg. §1.987-10(e)(3)(ii)(B)).

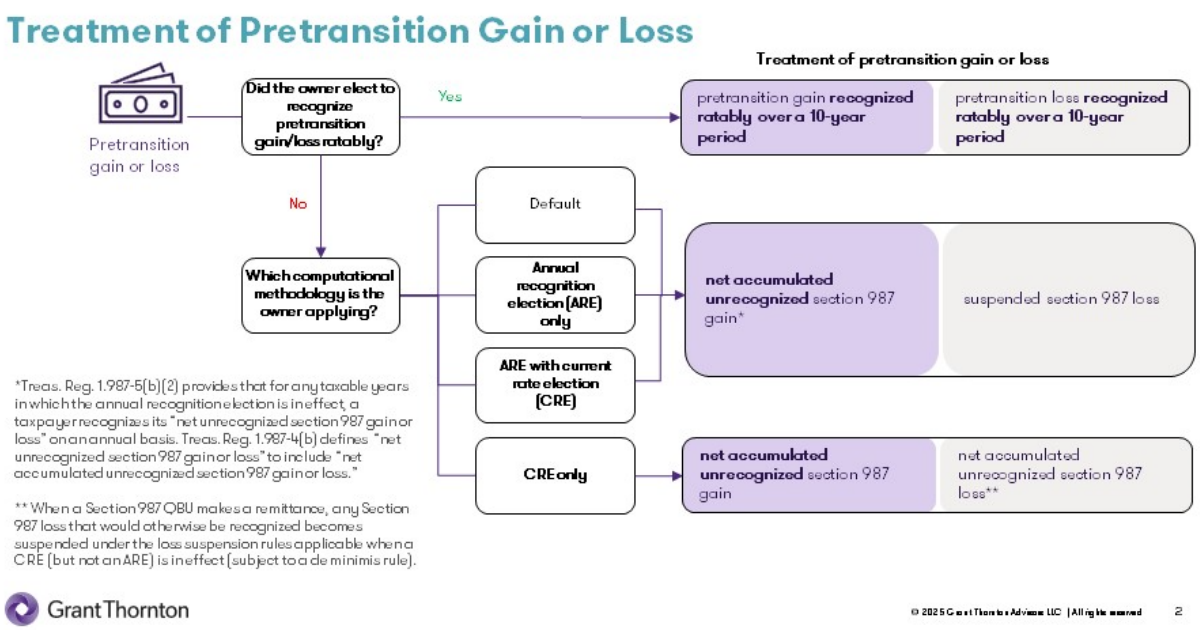
A §987 QBU owner that has applied an ineligible method must determine its annual unrecognized §987 gain or loss with respect to that QBU applying only steps 1 and 10 of the FEEP method as if the current rate election was in effect for all relevant tax years (Treas. Reg. §1.987-10(e)(3)(iii)). Effectively, this means taking year-end balance sheets each year to determine the change in OFCNV, translated at applicable spot rates, minus the change in OFCNV translated at the yearly average exchange rate for the taxable year (Treas. Reg. §1.987-4(d); Treas. Reg. §1.987-10(l)(4)).

Although this method is relatively straightforward in application, the requirement to obtain balance sheets dating back to 2006 can be quite challenging for certain taxpayers and the recomputation may also be quite time-consuming. Additionally, the determination of OFCNV may require certain adjustments being made to financial data (*Id*.).

Treatment of Pretransition Gain or Loss

Once the amount of the pretransition gain or loss has been determined, the next key question is how it should be treated. The regulations include complex rules for the treatment of §987 gain or loss, which may vary based on the applied computation methodology (with various elections), and suspended loss rules that may impact the taxpayer’s ability to benefit from these losses.

Generally speaking, the treatment of the pretransition gain or loss is determined by the methodology used to compute the §987 gain or loss, which is impacted by the elections made, such as the current rate election ("CRE") or the annual recognition election ("ARE"). The flow chart below illustrates the different treatment for each methodology.



Irrespective of the method applied, the taxpayer may make an election to recognize the pretransition gain or loss ratably over a ten taxable year period beginning with the taxable year that begins on the transition date (the "amortization election") (Treas. Reg. §1.987-10(e)(5)(ii)(A)). The final regulations also clarify that the amortization election applies in the case of a terminating QBU, treating any deferred §987 gain or loss, or suspended §987 loss, that was not recognized before the transition date as pretransition gain or loss subject to amortization (Treas. Reg. §1.987-10(e)(5)(ii)(C)).

If a taxpayer does not make an amortization election, then the general rules apply. Regardless of the computational methodology used, pretransition gain is generally treated as net unaccumulated unrecognized §987 gain (Treas. Reg. §1.987-10(e)(5)(i)(A)). It will then be added to the pool of net unrecognized §987 gain and be available to be recognized on a go-forward basis (Treas. Reg. §1.987-10(e)(5)(i)(A)).

If an ARE is not in place, any net unrecognized §987 gain will be deferred until a remittance occurs at some point in the future (Treas. Reg. §1.987-5(a)). However, if an ARE is in place, a taxpayer is required to recognize its net unrecognized §987 gains on an annual basis (Treas. Reg. §1.987-5(b)(2)). Since net unrecognized §987 gain includes both net accumulated unrecognized §987 gain and unrecognized §987 gain for the current taxable year, the ARE triggers recognition of not just current year unrecognized gain at the end of the first year to which §987 final regulations apply, but also any accumulated unrecognized §987 gain determined under the transition rules.

Therefore, taxpayers should consider whether to make the amortization election to spread the pretransition gain over 10 years as opposed to recognizing it all immediately in the first year under the ARE. Taxpayers that do not make the ARE and have net unaccumulated unrecognized §987 gain should consider whether deferring that gain until a future remittance is more favorable than spreading it over the 10-year period. Although deferral when the ARE is not in effect may generally be more favorable, there may be situations where the taxpayer anticipates a large remittance or another event that could trigger the entire pool. In such case, spreading it over 10 years may defer some of that gain to a future period.

Pretransition losses are generally subject to the suspended §987 loss rules, with one exception (Treas. Reg. §1.987-10(e)(5)(i)(B)). The IRS considers this rule necessary to prevent pretransition loss from being recognized without limitation (Preamble to T.D. 10016). Although the suspended §987 loss rules are beyond the scope of this article, those rules effectively defer the recognition of losses until a future gain occurs in the same recognition grouping (Treas. Reg. §1.987-11(e)). In other words, these losses generally won't be available until a corresponding gain is recognized.

As a result, the amortization election to recognize pretransition losses over the 10-year period may often be more beneficial than subjecting the taxpayer to the suspended loss rules. However, as with gains, some facts may produce different results, and a detailed analysis should be conducted. For example, it is important to consider whether the taxpayer anticipates significant future gains that allow for the recognition of those suspended losses before the 10-year period ends. Additionally, consider whether the owner will cease to exist without successor (e.g., as a result of a §331 liquidation), in which case the suspended loss may not be recognized (Treas. Reg. §1.987-13(f)).

The one exception applies when a CRE is in place and an ARE is not in effect. In this scenario, pretransition loss is treated as net accumulated unrecognized §987 loss (Treas. Reg. §1.987-10(e)(5)(i)(B)(2)), which are then added to the pool of net unrecognized §987 gain or loss (Treas. Reg. §1.987-4(b)). However, when a CRE (but not an ARE) is in effect, the owner's net unrecognized §987 loss, that would otherwise be recognized, becomes suspended (subject to a de minimis rule) (Treas. Reg. §1.987-11(c)). Therefore, a similar decision needs to be made with respect to suspended losses, including whether to make the amortization election to spread the pretransition loss ratably over a 10-year period.

Final Thoughts

As discussed above, the §987 regulations' transition rules are complex and contain many traps. Beyond this, the regulations themselves are a maze with several different paths that may apply to QBUs. The optimal path for each QBU may differ depending on the specific foreign currency situation of that QBU. As such, taxpayers must carefully evaluate these regulations in conjunction with an analysis of the methodology for computation they will be using on a go-forward basis. A comprehensive analysis will best position a taxpayer for navigating these challenging transition rules.

Taxpayers undertaking this challenge should review their existing structures to assess the impact of the §987 final regulations on their QBUs and determine what combination of elections are most beneficial. These assessments should focus on:

- **Identifying QBUs and determine pretransition method:** Assess whether QBUs are on an eligible pretransition method.
- **Identifying terminating QBUs:** Monitor QBUs for potential terminations after November 9, 2023, but before the year in which the §987 regulations are generally applicable.

- **Computing pretransition gain or loss:** Calculate any applicable pretransition gain or loss.
- **Preparing for Financial Statement implications:** Evaluate the impact on deferred tax assets/liabilities (DTA/DTL) by the finalization of the regulations.
- **Evaluating elections:** Assess and model various elections, such as the CRE, ARE, amortization election, etc. Given the complexity of the regulations, it's crucial to evaluate the impact of each election, as they each come with unique advantages and drawbacks.
- **Preparing for ongoing compliance:** Develop and maintain effective systems and procedures to ensure continuous compliance with the §987 regulations, including accurate tracking of attributes, computation of currency gain or loss, and appropriate financial reporting entries.