February 12, 2024

Mr. Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20220

Re: Comments on proposed regulations providing guidance on section 987 (NPRM REG–132422–17)

Dear Mr. Blessing:

The Alliance for Competitive Taxation ("**ACT**") is a coalition of leading American companies from a wide range of industries that supports a globally competitive corporate tax system.

Attached are ACT's comments on proposed regulations under section 987 on the taxation of foreign currency translation gains or losses arising from qualified business units ("**QBUs**") that operate in a currency other than the currency of their owner, as requested by NPRM REG–132422–17 (the "**2023 Proposed Regulations**"). We recognize and commend the efforts of the Treasury Department ("**Treasury**") and the Internal Revenue Service ("**IRS**") staff in issuing this guidance.

We appreciate your consideration of these comments. ACT members welcome the opportunity to discuss these comments further with your staff.

Yours sincerely,

Alliance for Competitive Taxation

cc: Lily Batchelder, Asst. Secretary for Tax Policy, U.S. Department of the Treasury
William M. Paul, Principal Deputy Chief Counsel, Internal Revenue Service
Scott Levine, Acting Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury

ALLIANCE FOR COMPETITIVE TAXATION RECOMMENDATIONS REGARDING THE CALCULATION OF INCOME AND CURRENCY GAIN OR LOSS WITH RESPECT TO A QUALIFIED BUSINESS UNIT

I. INTRODUCTION

In the preamble to the 2023 Proposed Regulations (the "**2023 Preamble**"), Treasury and the IRS strongly encouraged comments on this new set of proposed regulations. This document sets forth ACT's comments on the 2023 Proposed Regulations.

The comments are organized in the following manner:

A. Applicability Considerations
    1. Remove applicability date for terminating QBUs
    2. Defer general applicability date
    3. Application to banks and insurance companies
B. Transition Rules
    1. Clarify what constitutes a "reasonable manner" for applying an eligible pre-transition method
    2. Eliminate the requirement for taxpayers utilizing an "earnings only" method to treat the unrealized gain on capital as part of its pre-transition gain or loss
    3. Permit companies to use Cumulative Translation Adjustment ("CTA") as an eligible method
    4. Permit a shorter amortization period for pre-transition gain or loss
C. Current Rate Election and Computation Issues
    1. Current rate election (mechanics)
    2. Current rate election (manner of making or revoking election)
    3. Application to de minimis QBUs
D. Loss Suspension Rules
    1. Remove the "loss-to-the-extent-of-gain" rule for taxpayers making a current rate election
    2. If a version of the "loss-to-the-extent-of-gain" rule is retained, add a "look-back" rule to permit the owner to recognize suspended section 987 losses to the extent that the owner has recognized section 987 gains in prior tax years
    3. If a version of the "loss-to-the-extent-of-gain" rule is retained, treat all CFCs in the same controlled group as a single owner for purposes of the loss-to-the-extent-of-gain rule.
    4. If a version of the "loss-to-the-extent-of-gain" rule is retained, eliminate the requirement for a section 987 loss to be in the same "recognition grouping" as a recognized section 987 gain.
    5. If a version of the "loss-to-the-extent-of-gain" rule is retained, consider whether the loss-to-the-extent-of-gain rule should apply to section 987 QBUs that hold only a de minimis amount of historic assets and liabilities

6. Remove Prop. Reg. § 1.987-13(f) and (g) so that suspended section 987 losses are not permanently eliminated

E. Source and Character Rules
   1. Character and source rules (subpart F income groups)
   2. Character and source rules (year of determination)
   3. Assignment of section 987 gain or loss to its owned tested unit for GILTI high-tax election purposes

F. Other Issues
   1. Consolidated Groups
   2. Section 988 Transactions

Part A addresses matters related to the dates on which the regulations are proposed to be applicable, including the early applicability date for terminated QBUs as well as entities that should remain out of scope of the regulations.

Part B provides ACT's comments on the rules proposed to transition taxpayers to the methods provided in the 2023 Proposed Regulations.

Part C addresses computation matters related to the elections proposed under the 2023 Proposed Regulations.

Part D provides comments on the rules proposed to defer the recognition of certain section 987 losses.

Part E addresses the source and character of section 987 gains and losses and the treatment of section 987 gains and losses for GILTI high-tax election purposes.

Part F comments on other issues, including regulations proposed to recharacterize certain transactions between consolidated group members and rules for applying section 988 to transactions entered into by QBUs.

COMMENTS RELATING TO CERTAIN ASPECTS OF THE 2023 PROPOSED REGULATIONS

A. Applicability Considerations

1. Remove applicability date for terminating QBUs (Prop. Reg. § 1.987-14(a)(2))

Proposed Regulations

Prop. Reg. § 1.987-14(a)(2) provides that the 2023 Proposed Regulations apply to a section 987 QBU that terminates on or after November 9, 2023 or terminates as a result of an entity classification election filed on or after November 9, 2023 and that is effective before November 9, 2023.

Preamble Explanation

Treasury and the IRS proposed an accelerated applicability date provision due to concerns that taxpayers may terminate section 987 QBUs before the general applicability date applies to avoid the application of the 2023 Proposed Regulations.[1]

ACT Recommendation

Treasury and the IRS should remove Prop. Reg. § 1.987-14(a)(2) because the currently applicable final regulations under Treas. Reg. § 1.987-12 are sufficient to prevent abuse.

Reasons for ACT Recommendation

Treas. Reg. § 1.987-12, which is already effective, prevents the acceleration of section 987 losses in circumstances in which the branch continues in the hands of a "successor" QBU related to the taxpayer. The accelerated applicability date creates a trap for the unwary for taxpayers engaging in transactions unrelated to section 987 planning, such as business integrations, acquisitions, dispositions, and legal entity rationalization projects.

2. Defer general applicability date (Prop. Reg. § 1.987-14(a)(1))

Proposed Regulations

Prop. Reg. § 1.987-14(a)(1) provides the 2023 Proposed Regulations (and the parts of the 2016 and 2019 final regulations that are not replaced or modified by the 2023 Proposed Regulations) are proposed to apply to taxable years beginning after December 31, 2024.

Preamble Explanation

Treasury and the IRS did not provide an explicit rationale for the applicability date. The proposed effective date assumes that Treasury and the IRS finalize the regulations during calendar year 2024 and provides no deferral past that date.

ACT Recommendation

ACT recommends deferring the applicability date of the section 987 regulations, even if the 2023 Proposed Regulations are largely finalized as proposed, to no earlier than the taxable year beginning on or after one year after the first day of the first taxable year following the date on which the regulations are finalized.

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[1] 88 Fed. Reg. 78134, 78155 (Nov. 14, 2023).

Reasons for ACT Recommendation

Taxpayers need more time to implement final section 987 regulations.

Although a version of a foreign exchange exposure pool ("**FEEP**") method has been proposed since 2006, taxpayers were not required to adopt it, and many did not for the reasons identified in comments to such regulations.

Adding to the need for more time is the fact that the 2023 Proposed Regulations introduce myriad new rules and elections that taxpayers must understand, model, and operationalize. These include the new current rate election, which is intended to achieve a result similar to the section 987 proposed regulations published in 1991[2] (the "**1991 Proposed Regulations**"),[3] but require "fundamentally different computational methods" as compared to FEEP.[4] The 2023 Proposed Regulations also propose several major rules that have no equivalent in any of the previous versions of the section 987 regulations. For example, the 2023 Proposed Regulations require taxpayers to track suspended losses and their recognition grouping to match such suspended loss to future recognized section 987 gain in the same recognition grouping.

ACT's proposal is consistent with the effective date language from the proposed regulations published in 2006 (the "**2006 Proposed Regulations**")[5] and the final regulations published in 2016 (the "**2016 Final Regulations**").[6] Notably, one major reason for the delayed effective date was lack of adequate preparation time.[7]

For these reasons, Treasury and the IRS should defer the applicability date of the final regulations to no earlier than the taxable year beginning on or after one year after the first day of the first taxable year following the date on which the regulations are finalized.

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2 56 Fed. Reg. 48457 (Sept. 25, 1991).

3 *See* 88 Fed. Reg., at 78138-39 ("The current rate election is expected to produce an amount of section 987 gain or loss and section 987 taxable income or loss that is similar to the amounts determined under the 1991 proposed regulations.").

4 88 Fed. Reg., at 78138.

5 71 Fed. Reg. 52876 (Sept. 7, 2006). *See also* (2006) Prop. Reg. § 1.987-11(a).

6 81 Fed. Reg. 88806 (Dec. 8, 2016).

7 *See* Notice 2017-57, 2017-42 I.R.B. 325; *see generally* Notice 2017-38, 2017-30 I.R.B. 147.

3. Application to banks and insurance companies

Proposed Regulations

The 2006 Proposed Regulations and 2016 Final Regulations do not apply to a bank, insurance company, leasing company, finance coordination center, regulated investment company, or real estate investment trust (a "specified entity"), unless it engages in transactions primarily with related persons within the meaning of section 267(b) or section 707(b) that are not themselves specified entities.[8]

Preamble Explanation

Treasury and the IRS expressed concern that excluding these entities from the application of the 2023 Proposed Regulations would not provide taxpayers with sufficient guidance to ensure these entities are using an appropriate method to calculate their section 987 gain or loss and may risk such entities using different methods of applying section 987 that vary in material ways. The 2023 Preamble indicates that Treasury and the IRS believe that the current rate and annual recognition elections make compliance with the 2023 Proposed Regulations easier for financial entities.

The preamble to the 2006 Proposed Regulations acknowledged that the FEEP method would need to be precisely tailored to address issues unique to financial entities, including considerations around global dealing of currencies and securities. Issues specific to insurance companies, including reserves, surplus, and the treatment of investment assets held by separate trades or business, were also highlighted.

ACT Recommendation

ACT recommends retaining the exclusion in the 2016 Final Regulations for financial entities to permit time for additional study of the issues unique to such entities.

Reasons for Recommendation

Treasury and the IRS had previously acknowledged that financial entities pose unique challenges from a section 987 standpoint. For certain entities like banks that may operate in branch form globally, high volumes of daily transactions and the impact of the proposed rules for section 988 transactions may raise unique issues that have not yet been fully vetted. Insurance company issues (including the proper treatment of reserves) likewise need further consideration, as noted by Treasury and the IRS in the preamble to the 2006 Proposed Regulations. Because both the 2006 Proposed Regulations and 2016 Final Regulations excluded

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[8] *See e.g.*, Treas. Reg. § 1.987-1(b)(1)(ii).

these entities, many organizations are assessing the impact of a change in section 987 methodology for the first time. More time is needed to understand whether the newly proposed current rate and annual recognition elections mitigate concerns regarding the application of the FEEP method.

B. Transition Rules

1. Clarify what constitutes a "reasonable manner" for applying an eligible pre-transition method

Proposed Regulations

The 2023 Proposed Regulations require taxpayers to determine the amount of section 987 gain or loss unrealized as of the applicability date of the section 987 final regulations (the "**pre-transition gain or loss**") and take it into account in the post-transition period (subject to a variety of anti-abuse rules). Taxpayers on an "eligible" pre-transition method calculate their pre-transition gain or loss by determining what section 987 gain or loss would arise under their pre-transition method if the section 987 QBU were terminated on the day before the transition date. Taxpayers not on an eligible pre-transition method are required to compute their pre-transition gain or loss based on a simplified FEEP method.[9]

An eligible method is (i) any method producing the same amounts of lifetime income for the owner as the earnings and capital method, or (ii) the earnings only method (as long as it has been consistently applied and the owner first applied it on a tax return filed before November 9, 2023).[10] Further, the method must have been applied with respect to each taxable year beginning before the transition date, and any permissible change in pre-transition method must have been applied in a reasonable manner that would not result in income, gain, deduction, or loss (including section 987 gain or loss) being double counted or not counted at all.[11]

Preamble Explanation

Treasury and the IRS indicated that the term "eligible pre-transition method" generally includes any method of applying section 987 before the transition date that fully accounts for foreign currency gain or loss attributable to the assets and liabilities of a section 987 QBU.

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9 (2023) Prop. Reg. § 1.987-10(e)(3)(ii). The difference between the amount of section 987 gain or loss actually taken into account by the QBU in the pre-transition period and the amount recalculated under the simplified FEEP method represents the pre-transition gain or loss.

10 (2023) Prop. Reg. § 1.987-10(e)(4).

11 *Id.*

ACT Recommendation

Treasury and the IRS should clarify that a taxpayer is treated as having applied a pre-transition section 987 method in a "reasonable manner" so long as it has made a "good faith" effort to apply the method, including any reasonable modifications to make the method administrable.

Reasons for ACT Recommendation

The earnings and capital method must be applied in a "reasonable manner" to be considered an eligible method. No further explanation is provided as to what is considered reasonable.

Regulations on the application of section 987 have not been finalized since the enactment of section 987 in 1986. Not surprisingly, taxpayers have developed a range of methodologies since the enactment of the statute in an effort to comply in good faith with the statutory text. For example, many taxpayers apply a section 987 method based on the principles of the earnings only or earnings and capital method, but with some modifications (e.g., annual netting or grouping of disregarded entities using the same functional currency into a single QBU). Some taxpayers exclude ordinary course interbranch transactions when applying this method due to the volume of transactions each year.

Taxpayers not on an eligible method would be required to compute section 987 gain or loss since section 987 QBU's inception, which is unduly burdensome and, in many circumstances, not feasible due to data limitations. Because of the severity of the impact of not being on a reasonable method, ACT requests guidance to confirm that the application of a method with modifications to make such method administrable will be considered "reasonable."

2. Eliminate the requirement for taxpayers utilizing an "earnings only" method to treat the unrealized gain on capital as part of their pre-transition gain or loss

Proposed Regulations

Prop. Reg. § 1.987-10(e)(2)(B) requires a taxpayer to take into account a "net value adjustment" in the computation of its pre-transition section 987 gain or loss based on the difference between its assets and liabilities determined at the spot rate on the transition date versus the historic basis of such assets under its section 987 methodology.

Preamble Explanation

Treasury and the IRS are concerned that the use of a "spot-rate basis" for capital distributions under an "earnings only" method does not accurately measure the owner's economic income with respect to the section 987 QBU and does not capture the same amount of lifetime section 987 gain or loss as an earnings and capital method.

ACT Recommendation

Treasury and the IRS should permit a simplified method for taxpayers on an earnings only method of accounting to determine the net value adjustment.

Reasons for ACT Recommendation

Many taxpayers utilizing an earnings only method may not have the data required to compute this adjustment. Treasury and the IRS concede in the preamble that taxpayers may have interpreted the preamble to the 2006 Proposed Regulations to not require tracking the historic basis in assets under an earnings only method. Reconstructing these amounts going back to the formation of the branch would be burdensome to affected taxpayers and could result in outsized section 987 gains and losses being brought into the post-transition period for the same reasons that Treasury and the IRS expressed concern about the 1991 Proposed Regulations method. Permitting a simplified method, such as utilizing the financial statement determination of the unrealized translation adjustment, would reduce taxpayer burden and be more administrable for the IRS.

3. Permit taxpayers to use Cumulative Translation Adjustment ("CTA") as an eligible method

Proposed Regulations

Prop. Reg. § 1.987-10(e)(4)(iv) provides that a reasonable method of applying section 987 must require taking into account section 987 gain or loss upon a transfer of property from a section 987 QBU.

Preamble Explanation

Treasury and the IRS believe that a method that defers the recognition of section 987 gain or loss until the termination of the branch is inconsistent with the statutory requirements under section 987(3).[12]

ACT Recommendation

Treasury and the IRS should permit taxpayers who have consistently relied on their CTA account as an estimate of their unrealized section 987 gain or loss to treat this as an eligible method and treat such unrealized amounts as their pre-transition gain or loss.

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[12] 88 Fed. Reg., at 78151.

Reasons for ACT Recommendation

As discussed above, the requirement to recompute the pre-transition gain or loss under the simplified FEEP method is extremely burdensome to taxpayers that may not have the data needed to calculate these amounts. Given the data limitations, IRS audits of such calculations would be difficult to administer and time consuming for all parties involved.

By contrast, CTA accounts are part of a taxpayer's audited financial statements. Accordingly, they are subject to control procedures and oversight from a variety of non-tax sources. The workpapers supporting such accounts and descriptions of the environment in which they were created are available for IRS audit, making the standard easier to administer.

Moreover, because CTA is an audited account that is tracked for non-tax purposes, permitting taxpayers to rely on their CTA account for this purpose should not give rise to any concerns with respect to abuse or manipulation.

If the IRS and Treasury were concerned that permitting taxpayers to rely on their CTA accounts as a proxy for a more accurate method could create unintended results, an alternative would be to create safe harbors such as a safe harbor (similar to the existing section 987 de minimis rules) based on a percentage of the taxpayer's assets or income and a safe harbor that would limit the historic period of time (*e.g.*, 10 years) subject to the pre-transition gain or loss calculation.[13]

4. Permit a shorter amortization period for pre-transition gain or loss

Proposed Regulations

The 2023 Proposed Regulations permit taxpayers to elect to amortize their pre-transition gain or loss over a 10-year period (versus taking it into account when remittances are made and/or under the loss-to-the-extent-of-gain rule discussed in more detail below).

Preamble Explanation

No explanation was given for how this length of time was chosen.

ACT Recommendation

ACT recommends permitting taxpayers to elect a shorter time period for elective amortization of pre-transition gain or loss (either 4 years to correspond with the timing for a section 481(a)

[13] Such guidance could be provided to taxpayers in the form of a revenue procedure if there are concerns regarding the statutory support for a rule of administrative convenience.

adjustment or 5 years), while retaining the 10-year period for taxpayers that would prefer the longer time period.

Reason for ACT Recommendation

For some taxpayers, a shorter period would more closely align with companies' internal forecasting and planning windows and the time period over which other adjustments related to accounting methods are spread (even when the time period over which such adjustment accumulated is significantly longer than 4 years), while, for other taxpayers, a 10-year period (which aligns with the carryforward period for foreign tax credits in the branch basket) will result in better matching of section 987 gain or loss with relevant tax attributes. Accordingly, ACT recommends providing taxpayers greater flexibility regarding the amortization period for pre-transition gain or loss.

C. Current Rate Election and Computation Issues

1. Current rate election (mechanics) (Prop. Reg. § 1.987-1(d)(2))

Proposed Regulations

Prop. Reg. § 1.987-1(d)(2) provides an election to treat all assets and liabilities of a section 987 QBU as marked assets (the "**current rate election**"). If this election is made, all items of income, gain, deduction, and loss with respect to a section 987 QBU would be translated at the yearly average exchange rate for the respective taxable year and all balance sheet items of the section 987 QBU would be translated at the year-end spot rate for purposes of computing section 987 gain or loss.

Preamble Explanation

The preamble states that to address prior comments from taxpayers, the current rate election reduces the compliance burden of the FEEP method by eliminating the need to track the historic rate for historic items.

ACT Recommendation

Treasury and the IRS should amend the current rate election to compute section 987 gain or loss under such election using the computational mechanics of the "earnings and capital" method under the 1991 Proposed Regulations in lieu of the mechanics of the FEEP method. If Treasury and the IRS prefer to leave in the existing mechanics for the current rate election following the FEEP mechanics, an election should be made available to taxpayers to apply the mechanics of the earnings and capital method under the 1991 Proposed Regulations.

Reasons for ACT Recommendation

The current rate election would simplify the computation of section 987 gain or loss for many taxpayers, and ACT appreciates the efforts of Treasury and the IRS to lessen the compliance burden associated with the FEEP method. However, many taxpayers, including ACT members, who currently use the earnings and capital method would bear a significant cost if required to switch to the FEEP method with a current rate election. These taxpayers understand the mechanics of the earnings and capital method and have processes in place to ensure that the computation is performed reasonably and timely. These taxpayers also have processes in place to obtain the data needed to perform the computation. It seems unnecessary and unduly burdensome to require these taxpayers to bear the cost of changing from the earnings and capital method to the FEEP method with a current rate election if both methods produce substantially similar amounts of section 987 gain or loss using different mechanics.

If Treasury and the IRS revise the regulations to permit the use of the earnings and capital method when a current rate election is made, the regulations could include guardrails similar to those that apply when a taxpayer makes the current rate election, such as the rules related to suspended section 987 loss. The regulatory language in the 1991 Proposed Regulations that describes the earnings and capital method[14] has been in use for 32 years, so drafting similar language for inclusion in a future regulation should not be overly burdensome for the government.

2. Current rate election (manner of making or revoking election) (Prop. Reg. § 1.987-1(g)(3)(ii)(B))

Proposed Regulations

Prop. Reg. § 1.987-1(g)(3)(ii)(B) provides that the current rate election, once made or revoked, cannot be changed for five years unless the Commissioner consents.

Preamble Explanation

The 2023 Preamble states:

> These timing requirements are intended to make the proposed regulations easier to administer. In addition, because the Commissioner's consent is not required to make or revoke these elections, the timing requirements are needed to prevent taxpayers from opportunistically making or revoking elections in response to exchange rate fluctuations.

[14] *See* (1991) Prop. Reg. § 1.987-2.

ACT Recommendation

ACT recommends that, during the first five years in which the 2023 Proposed Regulations apply to a taxpayer, the taxpayer be permitted to make or revoke its current rate election without the consent of the Commissioner.

Reasons for the ACT Recommendation

Although this constraint is generally reasonable, we suggest that taxpayers be given more flexibility to make or revoke the election in the first few years of applying the 2023 Proposed Regulations. Most taxpayers have never applied the FEEP method and will make their initial decision with respect to the current rate election based on little data and experience. As they gather more information and experience with the new method, these taxpayers may reassess their initial decisions but would not be allowed to change those decisions for five years. Such initial efforts to find firm footing are distinguishable from opportunistic revisions in response to exchange rate fluctuations that Treasury and the IRS intend to prevent.

3. Application to de minimis QBUs

Proposed Regulations

For each section 987 QBU, the 2023 Proposed Regulations require that the owner compute section 987 gain or loss under the FEEP method (considering any elections made such as the current rate or annual recognition elections).

Preamble Explanation

Treasury did not specifically address the lack of a de minimis rule for section 987 QBUs with de minimis assets and liabilities.

ACT Recommendation

ACT recommends that a simplified method for computing section 987 gain or loss be made available for section 987 QBUs that hold a de minimis amount of assets and liabilities.

Reasons for ACT Recommendation

Due to economies of scale, the cost of complying with the regulations under section 987 is likely to be higher (relative to the potential amount of any section 987 gain or loss) for taxpayers that have fewer and smaller section 987 QBUs in their organizational structures. This disconnect between the compliance cost to such taxpayers and the benefit to the government could be bridged if taxpayers were allowed to apply a simplified rule to compute and realize section 987 gain or loss when the amount of section 987 gain or loss is very likely to be de minimis.

Ideally, this de minimis rule would permit taxpayers within its scope to follow a minimally modified version of the U.S. GAAP rules applicable to foreign currency translation gain or loss. Under these rules, a taxpayer would recognize section 987 gain or loss with respect to a section 987 QBU at the time that the taxpayer includes the relevant CTA in income from continuing operations for financial reporting purposes. Likewise, the amount of the section 987 gain or loss would be based on the amount of the CTA, subject to any adjustments needed to add or remove assets and liabilities that may be treated differently for financial accounting and U.S. federal income tax purposes (*e.g.*, intercompany loans between section 987 QBUs owned by the same regarded owner, certain equity interests in related corporations or partnerships). ACT believes that a reasonable definition of "de minimis" for this purpose would be $10 million, such that these rules may apply to a taxpayer whose section 987 QBUs hold in the aggregate assets with tax basis equal to or less than $10 million.

The plain language of section 987 indicates that a taxpayer realizes section 987 gain or loss at the time that it receives a remittance from its section 987 QBU, and ACT acknowledges that section 987 gain or loss would generally arise under the de minimis rule suggested above only when a taxpayer disposes of a section 987 QBU. Nevertheless, ACT believes that Treasury and the IRS have sufficient authority to modify this "remittance" element of the statute in the limited circumstances to which the proposed de minimis rule applies. Specifically, because the amount of section 987 gain or loss is directly proportional to the amount of tax basis a taxpayer has in the assets and liabilities of a section 987 QBU, a small amount of tax basis will give rise to a small amount of section 987 gain or loss. If the amount of section 987 gain or loss to be realized under the suggested de minimis rule is small, then the potential revenue loss to the government from permitting such an approach will also be small.

D. Loss Suspension Rules

1. Remove the "loss-to-the-extent-of-gain" rule for taxpayers making a current rate election

Proposed Regulations

The 2023 Proposed Regulations include the "loss-to-the-extent-of-gain" rule, which generally defers recognition of section 987 loss until an equivalent amount of section 987 gain is recognized in the same "recognition grouping." Under this rule, when an owner of section 987 QBUs makes a current rate election, any section 987 loss that the owner would otherwise recognize (but for the loss-to-the-extent-of-gain rule) is characterized as a suspended section 987 loss.[15] An owner's pool of suspended section 987 loss is tracked cumulatively over time,[16]

[15] *See* (2023) Prop. Reg. § 1.987-11(c).

[16] *See* (2023) Prop. Reg. § 1.987-11(b).

and the owner recognizes its accumulated suspended section 987 loss in a given tax year only to the extent that the owner recognizes section 987 gain from the same "recognition grouping" in the same tax year.[17]

Section 987 gain is considered to be in the same recognition grouping as suspended section 987 loss if the gain and loss are either assigned to U.S. source income or assigned to foreign source income in the same section 904 category.[18] In the case of an owner that is a controlled foreign corporation ("**CFC**"), the section 987 gain and suspended section 987 loss must also be assigned to the same category of statutory and residual grouping relevant to CFCs (*e.g.*, tentative tested income, subpart F income).[19]

Preamble Explanation

As a result of the current rate election, the owner of a section 987 QBU computes section 987 gain or loss not only on marked assets and liabilities but also on historic assets and liabilities. In the view of Treasury and the IRS, because no portion of the gain or loss attributable to an historic asset or liability is economically attributable to fluctuations in the value of currency, the current rate election artificially inflates section 987 gain or loss. Furthermore, because section 987 gain or loss is realized at the time of a remittance from the section 987 QBU, taxpayers exercise significant control over the time at which section 987 gain or loss is realized. Treasury and the IRS expressed concern in the preamble to the 2023 Proposed Regulations that, if a taxpayer makes the current rate election, that taxpayer could "choose to recognize significant, and potentially uneconomic, section 987 losses while avoiding or deferring section 987 gains."[20]

ACT Recommendation

Treasury and the IRS should remove the loss-to-the-extent-of-gain rule.

Reason for ACT Recommendation

The loss-to-the-extent-of-gain rule deprives taxpayers from the ability to recognize losses related to valid commercial transactions.

The loss-to-the-extent-of-gain rule relies on three separate faulty premises: (1) the loss calculated under the current rate election does not correspond to an economic loss suffered by the taxpayer; (2) the recognition of section 987 losses is the primary factor in determining

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17 *See* (2023) Prop. Reg. § 1.987-11(e)(1).

18 *See* (2023) Prop. Reg. § 1.987-11(f)(1).

19 *See* (2023) Prop. Reg. § 1.987-11(f)(2).

20 *See* 88 Fed. Reg., at 78139.

whether a taxpayer makes a remittance from a branch; and (3) deferral of the section 987 loss until the taxpayer has unrelated economic gains is a more appropriate result than recognition of the section 987 loss at the time of the remittance.

Treasury and the IRS assume that economic losses may be overstated because currency fluctuations produce economic gains or losses on assets other than financial assets and liabilities of a QBU. We believe that this core assumption is overbroad. As one commentator has noted:

> The owner of a QBU has an economic investment in the equity of the QBU and that equity includes all of the assets used in the active business of the QBU net of the liabilities associated with the business. Where the business of the QBU produces a foreign currency denominated revenue stream, the dollar value of the equity in that business is a function of the value of the foreign currency it earns. Even if the business has no financial assets, its dollar value can fall if the currency in which it earns its revenue depreciates against the dollar.[21]

Treasury and the IRS expressed concern that taxpayers could recognize section 987 losses on property like mobile personal property[22] and stock in subsidiaries.[23] This concern was exacerbated by the promulgation of the "check-the-box" regulations and the daily remittance method in the 1991 Proposed Regulations. Treasury and the IRS have proposed, and previously finalized, regulations intended to target what it views as the most troubling aspects of an earnings and capital section 987 method. Specifically, the exclusion of stock as an asset of a QBU, the annual netting convention for contributions and remittances, the requirement that a QBU engage in an "active" trade or business, the rules governing the determination of a QBU's functional currency, the deferral rules as finalized under Treas. Reg. § 1.987-12, and other anti-abuse rules in the 2023 Proposed Regulations protect the government from the recognition of significant tax losses based on events that have no commercial effect.

As a result of these anti-abuse rules, the loss-to-the-extent-of-gain rule is more likely to apply to normal commercial activities of a QBU transacting with its owner or another QBU owned by the same owner. The timing and frequency of such transactions is driven by non-tax commercial needs of the organization.

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[21] Chip Harter and Jeff Maddrey, *Code Sec. 987—Let's Fix the 1991 Proposed Regulations*, International Tax Journal, March-April 2007 at 13.

[22] *See* Preamble to the 2006 Proposed Regulations, 71 Fed. Reg., at 52879 (proffering an example of a QBU engaged in a mineral extraction activity in which the disregarded entity has no employees, contracts for all services with its U.S. corporation owner and received the extraction equipment via contribution from the U.S. corporate owner).

[23] *See* Notice 2000-20, 2000-1 C.B. 851; 71 Fed. Reg., at 52883.

Finally, the loss-to-the-extent-of-gain rule can defer losses indefinitely in circumstances in which a taxpayer (1) has QBUs all exposed to a similar currency environment (like the Euro zone), (2) is winding down its QBU operations, or (3) no longer operates in branch form. Deferral of losses in these kinds of situations is unnecessarily punitive in light of the other anti-abuse rules provided in the 2023 Proposed Regulations.

2. If a version of the "loss-to-the-extent-of-gain" rule is retained, add a "look-back" rule to permit the owner to recognize suspended section 987 losses to the extent that the owner has recognized section 987 gains in prior tax years.

Proposed Regulations

The owner of a QBU with a suspended loss recognizes all or a portion of its accumulated suspended section 987 loss in a given tax year only to the extent that the owner recognizes section 987 gain from the same "recognition grouping" in the same tax year.[24]

Preamble Explanation

Treasury and the IRS considered including a rule that permitted taxpayers to take into account section 987 gains previously recognized by the owner of a QBU in recognizing section 987 losses. Treasury and the IRS expressed concerns that taxpayers would "selectively trigger section 987 gain in taxable years in which such gain would not give rise to additional U.S. tax (for example, because the gain is offset by losses or because the additional U.S. tax is offset with foreign tax credits)."[25] Comments are solicited on whether a "look-back" rule should be provided and how such a rule could prevent section 987 gain that has no net effect on U.S. tax from releasing suspended section 987 loss that reduces U.S. tax.

ACT Recommendation

If the loss-to-the-extent-of-gain rule is retained, ACT recommends a "look-back" rule under which an owner of section 987 QBUs is permitted to recognize suspended section 987 losses to the extent of section 987 gains recognized in any tax year since the taxpayer transitioned to the 2023 Proposed Regulations or the final version thereof.

Reasons for ACT Recommendation

A "look-back" rule is necessary to prevent taxpayers from being whipsawed in circumstances in which economic gains are recognized before and economic losses are recognized after the

[24] *See* (2023) Prop. Reg. § 1.987-11(e)(1).

[25] *See* 88 Fed. Reg., at 78139.

implementation of the 2023 proposed regulations as finalized. Although the government is focused on the opportunistic recognition of uneconomic section 987 losses, it is important to note that the current rate election can also amplify the amount of section 987 gains. In this case, remittances occurring under normal commercial operations trigger a larger section 987 gain than the amount that would have been recognized under a FEEP method. Without a "look-back" rule, a taxpayer may not be able to recognize a suspended loss in a declining rate environment. Further, even in the situation in which a taxpayer recognizes section 987 gains in a tax year when foreign tax credits or losses are available to offset those gains, that offset will consume more attributes (foreign tax credits or losses, for example) that are otherwise available for the taxpayer to use. In addition, denying taxpayers the ability to deduct an economic currency-related loss because of concerns about that taxpayers' use of foreign tax credits or other attributes to shelter a prior economic currency-related gain introduces an entirely unrelated set of policy issues into the section 987 regulations, with no indication in the statutory text or legislative history that Congress intended or authorized such a limitation.

It is extremely difficult, both for taxpayers and the IRS, to evaluate the effect of triggering section 987 losses in a vacuum and, as such, it would be challenging or impossible for the IRS and Treasury to promulgate a rule that permits the ability to look back to prior section 987 gain in only "appropriate" circumstances. If, contrary to ACT's primary recommendation, Treasury and the IRS retain the loss-to-the-extent-of-gain rule, permitting taxpayers to look back at prior section 987 gains without any such limitations will provide an administrable rule for both the IRS and for taxpayers.

3. If a version of the "loss-to-the-extent-of-gain" rule is retained, treat all CFCs in the same controlled group as a single owner for purposes of the loss-to-the-extent-of-gain-rule

Proposed Regulation

The owner of a section 987 QBU (or the original suspended loss QBU owner) is permitted to recognize a portion of its total cumulative suspended section 987 loss in a recognition grouping to the extent of the amount of section 987 gain in that same recognition group for that owner.[26] In the case of a section 987 QBU of a CFC, this is the CFC owner.[27]

Preamble Explanation

The Preamble does not specifically address how this rule applies in the context of a CFC. When drafting the 2023 Proposed Regulations, Treasury and the IRS concluded that applying the loss-

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[26] (2023) Prop. Reg. § 1.987-11(e)(1).

[27] *See* (2023) Prop. Reg. § 1.987-1(b)(5).

to-the-extent-of-gain rule at the level of the section 987 QBU (as opposed to the level of the owner) would be "overly restrictive."[28] Treasury and the IRS reasoned that, if an owner has suspended section 987 loss from one section 987 QBU, any concern about opportunistic recognition of the "significant, and potentially uneconomic, section 987 losses" arising from the current rate election is mitigated to the extent that the owner also has section 987 gains from another section 987 QBU.[29]

ACT Recommendation

ACT recommends treating CFCs that are part of a specified group (as defined under Treas. Reg. § 1.163(j)-7(d)(2) principles, regardless of whether the taxpayer has made a section 163(j) group election) as a single owner for purposes of applying the loss-to-the-extent-of-gain rule.[30]

Reasons for ACT Recommendation

The inclusion of subpart F income and tested income is made at the U.S. shareholder level. Tested income and loss calculations for purposes of section 951A are made taking into account the tested income and loss of all of the CFCs in the group. For the same policy reasons that section 163(j) permitted taxpayers to "group" their CFCs together, CFCs ought to be treated as a single "owner" for applying the loss-to-the-extent-of-gain rule.

If each CFC in a group of CFCs owns section 987 QBUs and a single U.S. shareholder owns each of the CFCs, the reasoning outlined in the Preamble for an individual owner of section 987 QBUs would apply to the single U.S. shareholder. If one CFC realizes a section 987 loss and another CFC recognizes a section 987 gain in the same tax year, the section 987 gain and loss will be included in the U.S. shareholder's taxable income, where each will, at best, offset each other either in the tested income and loss calculation or the tax benefit/detriment economically in the U.S. shareholder's subpart F inclusion. We note that this is the "best case" scenario for the taxpayer, as other limitations on the computation of subpart F and tested income/loss may further limit the ability of the attributes to offset. Therefore, applying the loss-to-the-extent-of-gain rule at the U.S. shareholder level in this example ought not prompt the government's concern about opportunistic recognition of section 987 losses.

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[28] *See* 88 Fed. Reg., at 78139.

[29] *See id.*

[30] Generally, under this rule, a specified group includes one or more applicable CFCs or chains of applicable CFCs connected through stock ownership with a specified group parent. The specified group parent, which may be a U.S. corporation or an "applicable CFC" owns stock (80 percent ownership by value) in at least one applicable CFC and in each of the applicable CFCs owned by one or more of the other applicable CFCs.

4. **If a version of the "loss-to-the-extent-of-gain" rule is retained, eliminate the requirement for a section 987 loss to be in the same "recognition grouping" as a recognized section 987 gain.**

Proposed Regulation

The owner of a section 987 QBU does not recognize a section 987 loss from the current or a prior year (a "suspended section 987 loss") until it recognizes section 987 gain in the same "recognition grouping" as the suspended section 987 loss. A section 987 gain and suspended section 987 loss are generally in the same recognition grouping if they are both U.S. source income or if they are both foreign source income in the same section 904 category.

Preamble Explanation

The Preamble states that Treasury and the IRS are concerned that a section 987 QBU owner might trigger the recognition of section 987 gain that is not subject to residual U.S. tax or is taxed at a low rate to "release" a suspended section 987 loss of a different source or character.

ACT Recommendation

As noted, ACT believes that the loss-to-the-extent-of-gain rule should be eliminated. If some version of this rule is retained, however, ACT recommends eliminating the requirement that a section 987 gain and a section 987 loss must be in the same recognition grouping in order for the loss to be recognized.

Reasons for ACT Recommendation

The Internal Revenue Code and Regulations already contain numerous rules that limit the ability of taxpayers to utilize certain tax attributes (e.g., losses and deductions) against other attributes that have a different source or different characteristics. Expanding these limitations would significantly increase complexity for taxpayers and do nothing to advance the policy goals articulated by Congress in section 987 or its accompanying legislative history. As noted above, section 987 losses represent economic losses of a taxpayer, and taxpayers' ability to utilize economic losses in their overall tax computations is already heavily circumscribed by Congress and the Treasury in multiple separate sections of the Code and Regulations. ACT respectfully submits that adding further limitations to those already authorized by Congress is unnecessary and excessively burdensome on taxpayers.

5. If a version of the "loss-to-the-extent-of-gain" rule is retained, consider whether the loss-to-the-extent-of-gain rule should apply to section 987 QBUs that hold only a de minimis amount of historic assets and liabilities

Proposed Regulation

The loss-to-the-extent-of-gain rule applies without limitation for the size of the QBU, its attributes or assets and liabilities.

Preamble Explanation

None.

ACT Recommendation

ACT recommends that the loss-to-the-extent-of-gain rule not apply to section 987 QBUs that hold primarily financial assets (*i.e.*, assets that would have been marked assets under the FEEP method).

Reasons for ACT Recommendation

If a section 987 QBU holds only a de minimis amount of historic assets and liabilities, the owner may still prefer to make a current rate election to avoid the burden of tracking the historic rates applicable to those historic items or to more closely align accounting for section 987 gain and loss under the 2023 Proposed Regulations with its historic section 987 calculation process and data inputs. Such a section 987 QBU will not generate significant nor uneconomic section 987 losses because it holds relatively few historic assets and liabilities. If the purpose of the loss-to-the-extent-of-gain rule is to protect against such significant and uneconomic section 987 losses, ACT suggests that the loss-to-the-extent-of-gain rule need not apply to section 987 loss produced by a section 987 QBU with only a de minimis amount of historic assets and liabilities.

For this purpose, a section 987 QBU could be considered to hold a de minimis amount of historic assets if the tax basis and adjusted issue price attributable to the QBU's historic assets and liabilities is less than 5% of the tax basis and adjusted issue price attributable to all of the QBU's assets and liabilities.

6. Remove Prop. Reg. § 1.987-13(f) and (g) so that suspended section 987 losses are not permanently eliminated

Proposed Regulation

Under Prop. Reg. § 1.987-13(g), if an owner of a section 987 QBU with suspended section 987 loss or an original suspended loss QBU owner ceases to exist in an inbound section 332 liquidation or in an inbound reorganization described in section 381(a)(2), any suspended

section 987 loss of the owner or original suspended loss QBU owner that is not recognized after application of the loss-to-the-extent-of-gain rule is eliminated.

Under Prop. Reg. § 1.987-13(f), if an original suspended loss QBU owner ceases to exist in a transaction not described in section 381(a) (*e.g.*, a liquidation under section 331), then any suspended section 987 loss that is not recognized after applying the loss-to-the-extent-of-gain rule is eliminated.

Preamble Explanation

Treasury and the IRS are concerned that, if a domestic corporation succeeds to the suspended section 987 loss of a foreign corporation under section 381, the inbounded suspended section 987 losses "may relate to income subject to tax at a significantly reduced effective rate."[31] Similarly, Treasury and the IRS included Prop. Reg. § 1.987-13(f) to prevent taxpayers from recognizing suspended section 987 losses by entering into a transaction that removes the original suspended loss QBU owner from the controlled group without leaving a successor in place.[32]

ACT Recommendation

ACT recommends preserving any suspended section 987 loss offshore rather than eliminating the section 987 loss entirely.

Reasons for ACT Recommendation

ACT understands Treasury and the IRS's concern that "importing" a section 987 loss into the United States may change the effective tax rate at which the loss is taken into account. However, it is unclear what policy reason supports completely eliminating the loss (as opposed to, for example, suspending the loss offshore). In fact, eliminating section 987 losses when a company chooses to bring assets back to the United States may counteract the intended policy effect of other tax statutes and regulations that exist to encourage U.S. companies to bring intellectual property and other assets back to the United States.

ACT believes there are alternatives to eliminating the loss that would keep foreign-derived suspended section 987 losses out of a domestic entity. For example, final regulations could provide that, rather than being eliminated, the suspended section 987 losses be treated as suspended losses of the CFC group (if the recommendation above is adopted for CFCs), the original CFC owner (if such owner exists after the inbound transaction), or allocated pro rata

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[31] *See* 88 Fed. Reg., at 78141.

[32] *See id.*

among the U.S. shareholder's other foreign owners of section 987 QBUs in a manner similar to that by which suspended section 987 losses are attributed to successor suspended loss QBUs under Prop. Reg. § 1.987-13(b)(1)(ii).

E. Character and Source Rules

1. Character and source rules (subpart F income groups) (Prop. Reg. § 1.987-6(b)(2)(i)(C))

Proposed Regulations

Prop. Reg. § 1.987-6(b)(2)(i)(C) provides that section 987 gain or loss assigned to subpart F income groups is treated as foreign currency gain or loss attributable to section 988 transactions not directly related to the business needs of the CFC and is taken into account for purposes of determining the excess of foreign currency gains over foreign currency losses as foreign personal holding company income ("**FPHCI**") under section 954(c)(1)(D).

Preamble Explanation

Treasury and the IRS requested comments as to whether it would be appropriate to eliminate this rule and characterize section 987 gain or loss by reference to subpart F income groups (as defined in Treas. Reg. § 1.960–1(d)(2)(ii)(B)) or whether to retain this rule generally but apply a different rule to taxpayers that make a current rate election.

ACT Recommendation

ACT recommends that Prop. Reg. § 1.987-6(b)(2)(i)(C) be eliminated and section 987 gain or loss be characterized by reference to subpart F income groups.

Reasons for ACT Recommendation

By sourcing all section 987 gain or loss to FPHCI under section 954(c)(1)(D), such section 987 gain or loss would be sourced to passive subpart F income, even if subpart F income earned by the section 987 QBU was general basket subpart F income (*e.g.*, foreign base company sales or services income). In such instances, section 987 gain or loss would not be able to net against the foreign base company sales or services income that the section 987 QBU's assets generated. This could result in a distortion and uneconomic result because the assets could generate foreign base company sales or services income but the corresponding section 987 loss arising from such assets would not be able to reduce such income and would become stranded in passive subpart F income.

2. Character and source rules (year of determination) (Prop. Reg. § 1.987-6(b)(1))

Proposed Regulations

Prop. Reg. § 1.987-6(b)(1) provides that the character and source of section 987 gain or loss is determined initially in the year of the remittance, subject to reassignment in the year in which the section 987 gain or loss is recognized to account for the application of rules based on a net income computation such as the various high-tax exceptions.

Preamble Explanation

Treasury and the IRS requested comments as to whether it would be appropriate to determine the source and character of unrecognized section 987 gain or loss by making the initial assignment in the taxable year in which the section 987 gain or loss is initially included in unrecognized section 987 gain or loss under Prop. Reg. § 1.987-4(d), rather than in the year of a remittance. In making this request, Treasury and the IRS noted that under the current proposed rule for determining source and character in the year of a remittance, distortions arise from changes in the bases of a section 987 QBU's assets or shifts in the character of its income or assets between the time that unrecognized section 987 gain or loss is added to the pool and the year of the remittance.

ACT Recommendation

ACT recommends that the character and source of section 987 gain or loss be determined in the taxable year such section 987 gain or loss is recognized and not the year of the remittance.

Reasons for ACT Recommendation

ACT acknowledges and appreciates that Treasury and the IRS provided the year of remittance is the year that section 987 gain or loss is initially determined to alleviate the burden of extensive tracking that would be required if it were determined annually when included in unrecognized section 987 gain or loss. However, requiring the character and source of section 987 gain or loss to be tracked in the year of the remittance rather than the year of recognition is still administratively burdensome on taxpayers and requires tracking of section 987 gain or loss in separate categories for potentially numerous years and numerous section 987 QBUs.

Treasury and the IRS acknowledged that the proposed rule may give rise to distortions due to changes in the bases of a section 987 QBU's assets or shifts in the character of its income or assets between the time unrecognized section 987 gain or loss is added to the pool and the year of the remittance. Such distortions would be no worse or better if the character and source of section 987 gain or loss were determined in the year of recognition but the compliance burden to the taxpayer would be significantly reduced if the determination were made in the year of recognition.

3. Assignment of section 987 gain or loss to its own tested unit for GILTI high-tax election purposes (Prop. Reg. § 1.987-6(b)(2)(iii))

Proposed Regulations

Prop. Reg. § 1.987-6(b)(2)(iii) provides that, if a GILTI high-tax election is made under Treas. Reg. § 1.951A-2(c)(7)(viii), it applies to all of the section 987 gain or loss in a tentative tested income group that is recognized by the CFC in the taxable year as if the section 987 gain and loss were all assigned to its own separate tested unit of the CFC.

Preamble Explanation

None.

ACT Recommendation

ACT recommends that the section 987 gain or loss that is recognized by the CFC in the taxable year not be assigned to its own separate tested unit of the CFC for GILTI high-tax election purposes.

Reasons for ACT Recommendation

Treasury and the IRS acknowledged that under the proposed rule "a tentative tested income item consisting of section 987 gain may often have a zero percent effective rate of foreign tax and, therefore, would generally not qualify for the GILTI high-tax exclusion."[33] Such a result would subject a taxpayer to GILTI liability in circumstances where section 987 gain is recognized by a CFC operating in a jurisdiction subject to high rates of foreign tax, and there is no explanation given as to why such a result is appropriate. ACT therefore believes a reevaluation of that proposed rule is warranted.

F. Other Issues

1. Consolidated Groups

Proposed Regulation

When a consolidated group member's section 987 QBU and another group member (or another group member's section 987 QBU) transact, Prop. Reg. § 1.1502-13(j)(9) bifurcates the transaction into two transactions: (1) a transaction between the two group members and (2) a remittance or contribution between the section 987 QBU and its owner.

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[33] 88 Fed. Reg., at 78144.

Preamble Explanation

To illustrate the challenge of applying the matching rule in such situations, the preamble to the 2023 Proposed Regulations provides the following example:

> [A]ssume that Lender . . . and Borrower . . . are members of a consolidated group, and Lender has a section 987 QBU (Lender QBU) whose functional currency is the euro. Lender QBU lends €100 to Borrower.[34]

The preamble further describes how these facts would be treated if Borrower and Lender were divisions of a single corporation, as provided in the matching rule:

> If Borrower and Lender were divisions of a single corporation, the loan would be treated as a transfer from Lender QBU when funded and a transfer to Lender QBU when repaid (or when interest is paid). These transfers would be taken into account in determining the amount of a remittance from Lender QBU (potentially triggering the recognition of section 987 gain or loss), and the single corporation might recognize section 988 gain or loss when the loan is repaid. See §§ 1.987-5 and 1.988-1(a)(10)(ii)(A).[35]

Treasury and the IRS acknowledge that, under current law, Lender would take into account its FX gain or loss with respect to Lender QBU's euro-denominated loan receivable under section 987 when Lender QBU makes remittances or terminates, and Borrower would take into account its FX gain or loss with respect to the euro-denominated loan payable under section 988 when Borrower makes payments of principal and interest. Because Lender's section 987 gain or loss will not match Borrower's section 988 gain or loss either in amount or timing, the result under current law is not the same as the result if Borrower and Lender were divisions of a single corporation. Treasury and the IRS view this result under existing law as inconsistent with the matching rule under Treas. Reg. § 1.1502-13.

ACT Recommendation

ACT proposes removing the proposed consolidated group regulation.

Reasons for ACT Recommendation

The proposed regulation goes beyond merely matching the timing and character of recognition of gain and loss on the transactions between consolidated group members to changing the

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34 *See id.*, at 78153.

35 *See id.*

amount of gain or loss for each of the parties. This change has downstream consequences for U.S. federal, state, and non-U.S. tax purposes.

Under current law, in the simplified example in the Preamble, Borrower has transactional foreign currency gain or loss based on the date on which it issued the loan and the date(s) on which payments are made.[36] The owner of Lender has translational foreign currency gain or loss as the Euro loan asset impacts Lender's section 987 Euro pool. This characterization matches the way in which foreign currency exposure is viewed for financial statement and local tax purposes, resulting in minimal distortion for CAMT, Pillar 2, and state tax purposes. Recharacterizing the transaction eliminates the economic exposure for Borrower in the example for U.S. federal income tax purposes, creating a difference from the financial statement exposure (raising CAMT considerations) and potential differences from a state tax standpoint (depending on whether the states conform to federal law, etc.).

Corporate treasury functions generally execute hedging transactions to offset the foreign currency exposures seen from a financial accounting perspective. For instance, in the example included in the Preamble and discussed above, the taxpayer's treasury function might enter into a EUR-USD forward contract to manage Borrower's Euro balance sheet exposure on the Euro-denominated loan payable. The taxpayer's treasury function does not hedge the offsetting exposure created under Prop. Reg. § 1.1502-13(j)(9) because this exposure generates no commercial foreign currency exposure.

This mismatch between the commercial currency exposure arising from the actual facts and the deemed currency exposure arising from the facts as recast under Prop. Reg. § 1.1502-13(j)(9) creates tax exposure for the U.S. consolidated group on a hedging strategy chosen to mitigate the economic currency risk.

ACT appreciates Treasury's and the IRS's efforts to clarify how the matching rule applies to intra-group transactions involving section 987 QBUs. However, ACT respectfully requests that Treasury and the IRS also consider the problems that arise from the mismatch between the facts as recast under Prop. Reg. § 1.1502-13(j)(9) and companies' financial accounting and hedging activities.

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[36] *See* Treas. Reg. § 1.988-2(b)(6).

2. Section 988 Transactions

Proposed Regulations

Prop. Reg. § 1.987-3(b)(4)(i) of the section 987 proposed regulations published in 2016 (the "**2016 Proposed Regulations**")[37] provides that whether a transaction is a section 988 transaction is determined by reference to the section 987 QBU's functional currency, but any section 988 gain or loss is determined by reference to the owner's functional currency. Prop. Reg. § 1.987-3(b)(4)(iii) of the 2016 Proposed Regulations provides an exception for certain short-term obligations that are accounted for under a mark-to-market method of accounting, where such obligations produce section 988 gain or loss as determined against the section 987 QBU's functional currency.

Prop. Reg. § 1.987-3(b)(4)(i) of the 2016 Proposed Regulations provides that certain transactions of a section 987 QBU that are denominated in, or determined by reference to, the owner's functional currency are not treated as section 988 transactions of the section 987 QBU.

Preamble Explanation

Treasury and the IRS acknowledge that the 2016 Proposed Regulation rules on section 988 transactions increase the compliance burden on taxpayers in certain contexts.[38] Treasury and the IRS express concern that a rule that makes all section 988 determinations measured against the section 987 QBU's functional currency could allow the owner of the QBU to selectively realize losses because it holds offsetting positions (the interest in the section 987 QBU and the section 987 QBU's interest in the section 988 transactions denominated in the owner's functional currency). Treasury and the IRS solicit comments on whether section 988 gain or loss should be determined by reference to the functional currency of the section 987 QBU when a current rate or annual recognition election is in effect and, if so, what limitations could be imposed to prevent abuse.

ACT Recommendation

ACT recommends replacing these proposed regulations with a rule that provides that the determination of whether a transaction is a section 988 transaction and the amount of foreign currency gain or loss is determined by reference to the section 987 QBU's functional currency. To the extent necessary, Treasury and the IRS could pursue guidance under other provisions in a separate regulations package to address abuses actually observed, if any, after the implementation of such a rule.

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[37] 81 Fed. Reg. 88882 (Dec. 8, 2016).

[38] 88 Fed. Reg., at 78154.

Reasons for Recommendation

The 2016 Proposed Regulations are difficult and may be impossible to administer in a global organization.

As a starting point, for all non-U.S. federal income tax purposes, the determination of whether a transaction gives rise to a foreign currency exposure is made based on the functional currency of the entity that entered into the transaction. Requiring U.S. federal income tax calculations that recalculate all of the foreign currency gains and losses for all section 987 QBUs is a massive undertaking the results of which will differ completely from the financial statement presentation of these items.[39] As illustrated above in the discussion of transactions within a U.S. consolidated group, this can result in mismatches between the commercial exposure (including exposures the taxpayer may hedge as part of its prudent treasury management process), local tax exposure, and the U.S. federal income tax recharacterization. The results are difficult for the IRS to audit and create downstream consequences under CAMT and other minimum tax regimes.

Although the short-term obligation rule is a good start, for global organizations with cash pool balances, intercompany lending, and cash flow hedging programs for anticipated costs and revenues the usefulness of the rule is limited.

There are existing rules outside of section 987 intended to address offsetting positions. In 2017, Treasury and the IRS published proposed regulations addressing hedging activities for CFCs, including a broader hedge timing rule specifically applicable to offsetting exposures in foreign currency. Treasury's and the IRS's concerns regarding offsetting positions may be better addressed under other financial instruments rules, such as the tax straddle rules under section 1092 (which are designed to address offsetting positions) and by expanding the elective mark-to-market regime under Prop. Reg. § 1.988-7. These regulations projects could be taken up separately to provide the opportunity for meaningful notice and comment on proposed approaches.

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39 Under current law, taxpayers are required to make adjustments that deviate from following the financial statement and/or internal ERP system foreign currency determinations when either (1) the U.S. federal income tax functional currency is different than the financial statement reporting currency, or (2) the entity does not rise to the level of a section 987 and 989 QBU, such that it uses the functional currency of its owner. These circumstances tend to be rare, and the specifics of the situation – like a holding company with minimal activity – allow the adjustments to be made because there are relatively few transactions for which adjustments are required. The current proposal may require the recalculation of FX gains and losses on millions of transactions.