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KPMG report: Proposed regulations under section 987, initial observations and analysis

The U.S. Treasury Department and IRS on November 9, 2023, released [proposed regulations](#) [PDF 1 MB] under section 987 (“2023 Proposed Regulations”) for publication in the Federal Register. The 2023 Proposed Regulations broadly follow the structure outlined in the proposed regulations published on September 7, 2006 (71 FR 52876) and finalized on December 8, 2016 (T.D. 9794) (“2016 Final Regulations”), otherwise known as the foreign exchange exposure pool (FEEP) method. Several notices, including, most recently, Notice 2022-34, have deferred the applicability date of the 2016 Final Regulations until tax years beginning after December 7, 2023.

As originally proposed, the FEEP method required taxpayers to calculate unrecognized section 987 gain or loss for the year by computing the change in the net value of the section 987 qualified business unit (QBU) in the taxpayer’s functional currency and adjusting for the section 987 QBU’s current year taxable income or loss, tax exempt income, and nondeductible expenses. Pursuant to the 2016 Final Regulations, the net value of the section 987 QBU was computed by translating items of asset and liability into the taxpayer’s functional currency at either a historic rate or spot rate, generally depending on whether the asset or liability is financial in nature. The taxable income or loss, tax-exempt income, and nondeductible expenses computed in the QBU’s functional currency were translated into the owner’s functional currency at the average exchange rate for the year with certain important exceptions (e.g., depreciation, amortization, and cost of goods sold (COGS)). The unrecognized section 987 gain or loss for the year was added to an unrecognized section 987 pool that the taxpayer maintained on a rolling basis. If the section 987 QBU made a remittance for the year, the taxpayer recognized a portion of the unrecognized section 987 gain or loss based on the percentage of the section 987 QBU’s assets remitted (or deemed remitted).

The FEEP method was a significant departure from the method proposed on September 25, 1991 (56 FR 48457) (“1991 proposed method”) and the earnings only method discussed in Notice 2000-20. Since the FEEP method was first proposed in 2006, each of the FEEP method, the 1991 proposed method, and the earnings only method has been broadly accepted as a reasonable application of section 987 in the absence of any final regulations.

Though the 2023 Proposed Regulations retain the FEEP method framework, there are several notable changes summarized below.

- Previously excluded entities are brought within scope—the 2023 Proposed Regulations will apply to banks, insurance companies, leasing companies, finance coordination centers, RICs, and REITs. These entities were previously excluded from the scope of the 2016 Final Regulations and were instead required to apply section 987 in a reasonable manner.
- The mechanical steps to compute unrecognized section 987 gain or loss are generally consistent with the 2016 Final Regulations with some minor adjustments.
- New elections intended to simplify application of the FEED method
 - Current rate election—the 2023 Proposed Regulations include an election to translate all balance sheet items properly attributable to a section 987 QBU at the year-end spot rate and to translate all income statement items using the average rate for the year. The preamble notes that the election should produce results that are similar to those produced under the 1991 proposed method.
 - Annual recognition election—separately or in addition to the current rate election, a taxpayer may elect to recognize unrecognized section 987 gain or loss of a section 987 QBU on an annual basis. This election is a modification of the annual deemed termination election proposed in 2016 (81 FR 88882). Under the election, the applicable rate to translate balance sheet items will depend on whether there is also a current rate election in effect in the same year. Income or loss is translated at the average rate for the year.
- New loss limitation rules may apply to suspend the recognition of a section 987 loss until the taxpayer recognizes an equal amount of section 987 gain with the same source and character as the suspended loss, depending on whether one or both of these elections are in effect (and if their effective dates are aligned). Subject to limitations, the termination of a QBU can also trigger a suspended section 987 loss.
- The 2023 Proposed Regulations would broaden the scope of section 987 losses that may be deferred or suspended. In some instances, these losses may be lost completely, such as in connection with a taxable liquidation of the owner.
- Source and character
 - Consistent with the 2016 Final Regulations, section 987 gain or loss is apportioned under the asset method provided in Treas. Reg. § 1.861-9 and 9T. Section 987 gain or loss of a CFC may therefore be treated as subpart F income, tested income, or neither.
 - If section 987 gain or loss of a CFC is allocated to subpart F income, it is treated in the same manner as section 988 gain or loss that does not qualify for the business needs exception.
 - To the extent allocated to tested income, the 2023 Proposed Regulations provide that section 987 gains and losses are not attributable or allocable to the CFC tested unit or any other tested unit of a CFC but are grouped as a separate tentative tested income item. As such, this separate tentative tested income item consists solely of the CFC's net total section 987 gains and losses for the tax year. This has the effect of ensuring that section 987 gains or losses do not distort the outcome of the GILTI high-tax exclusion provided in Treas. Reg. § 1.951A-2(c)(7) (GILTI HTE) to the operating income of the CFC or its other tested units. Further, because section 987 gains are treated as a separate tentative tested income item which foreign jurisdictions generally do not tax, section 987 gains that are treated as tested income would not qualify for the GILTI HTE.
- The 2023 Proposed Regulations include a hybrid approach to partnerships other than section 987 aggregate partnerships (i.e., partnerships that are wholly owned by related persons) whereby the partnership is treated as the owner of section 987 QBUs on an entity theory but partners track unrecognized section 987 gain or loss on aggregate theory.

- Consolidated groups—the 2023 Proposed Regulations include new rules that would treat transactions between a section 987 QBU of a consolidated group member with another member as two transactions: a transaction between the section 987 QBU and its owner and an additional transaction between the owner and the other member.
- Changes to the transition rule
 - The “fresh start” transition in the 2016 Final Regulations has been withdrawn and replaced with a new transition rule that attempts to preserve historic section 987 gain or loss. Unless a taxpayer has appropriately applied the “fresh start” transition rule in the 2016 Final Regulations on a return filed before November 9, 2023, the 2023 Proposed Regulations require a taxpayer to compute a “pretransition” section 987 gain or loss amount as of the transition date using the spot rate on the day before the transition date. If the taxpayer was applying an eligible section 987 method, this pretransition section 987 gain or loss is computed under that method. An eligible method includes the 1991 proposed method. The earnings only method may also be an eligible method, but only if the taxpayer had applied it on a tax return filed before November 9, 2023, and certain other requirements are satisfied, including consistency requirements. Taxpayers that were not on an eligible section 987 method will need to compute unrecognized section 987 gain or loss under a modified FEEP method for all years beginning with the date of section 987 QBU inception.
 - Upon transition, the beginning net value of the section 987 QBU in the taxpayer’s functional currency will be determined using the spot rate on the day before the transition date.
- Applicability date
 - The 2023 Proposed Regulations provide that the regulations under section 987 that are currently subject to deferral (both those portions changed by these Proposed Regulations and those left unchanged by the Proposed Regulations) will be effective for tax years beginning on or after January 1, 2025. The 2023 Proposed Regulations, once finalized, would allow a taxpayer to early adopt these finalized regulations in their entirety and subject to consistency requirements for taxable years ending after November 9, 2023. Alternatively, taxpayers can choose to apply the 2016 Final Regulations (as amended in 2019) in their entirety to tax years beginning after December 7, 2016, and beginning on or before December 31, 2024, similarly subject to consistency requirements. However, unless a taxpayer first applied the 2016 Final Regulations on a return filed before November 9, 2023, a taxpayer choosing to apply the 2016 Final Regulations is nevertheless subject to the transition rule contained in the 2023 Proposed Regulations and therefore does not benefit from the “fresh start” transition rule contained in the 2016 Final Regulations applying to eliminate pre-transition section 987 gain. In addition, the preamble permits taxpayers to rely on the 2023 Proposed Regulations for tax years ending after November 9, 2023 (again, if applied in their entirety and subject to consistency requirements). It appears that for a tax year beginning between November 9, 2023, and December 31, 2024, a taxpayer that makes none of those elections is left to reasonably construe the statute.
 - The 2023 Proposed Regulations modify the applicability date for certain transactions, including section 987 QBU terminations such that the regulations would apply to the QBU on its termination.

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