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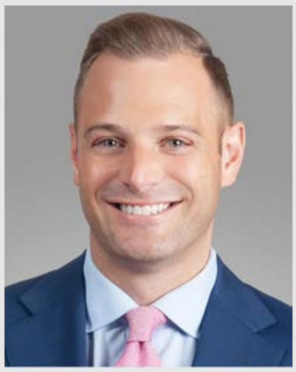

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In this article, Greenwald and Rietveld explain new section 987 regulations and why an "angel list" election is also needed.

On November 14, 2023, Treasury and the IRS issued new, proposed regulations under section 987.[1] The proposed regulations seek to simplify the required section 987 computations under the foreign exchange exposure pool (FEEP) method (first proposed in 2006) with:

- an election to treat all items of a qualified business unit (QBU) as "marked items" subject to a loss suspension rule (the current rate election and the loss-to-the-extent-of-gain rule); and
- an election to recognize all foreign currency gain or loss of a QBU annually (the annual recognition election), which has replaced the annual deemed termination election of the 2016 temporary and proposed regulations.[2]

While these new elections are welcome, one more is needed — an election to exclude from the definition of historic asset (and, therefore, from the section 987 computations completely) all low-value and quickly turning assets that do not contribute to the competitive advantages, core capabilities, or fundamental risks of success or failure in one or more of a taxpayer's trades or businesses (angel list election).

The angel list election would exclude from the definition of historic asset:

- any individual asset with an adjusted basis or cost basis of $50,000 or less (adjusted for inflation as reflected in the consumer price index); and
- any asset that the commissioner specifies by revenue procedure.

Assets will be included in the revenue procedure based on the commissioner's determination that the specified assets are:

- of relatively low value;
- have a short useful life; or
- do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure.[3]

These assets might include:

- prepaid expenses;
- office furniture, fixtures, and equipment;

[1] 88 F.R. 78134.

[2] The 2023 proposed regulations also introduce a new transition rule and applicability dates (discussed below).

[3] The commissioner may add to, subtract from, or otherwise revise the specified assets described in the revenue procedure by subsequent revenue procedures, with the amendments ordinarily being prospective in effect.

- computers and peripherals;
- typewriters, calculators, copiers, and other duplicating equipment;
- cell phones, PDAs, and any other small electronic communication devices;
- automobiles;
- light and heavy general-purpose trucks, tractors, and trailers;
- leasehold improvements; and
- any other asset that the taxpayer can demonstrate does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more of its trades or businesses.

The benefits of the angel list election to both tax administrations and taxpayers' tax compliance obligations should be immediately obvious, and the effect on federal revenue should be modest at most.

In this article, we first review the long and tortured history of the section 987 regulations and the FEEP method. We then review the 2023 proposed regulations, with a particular emphasis on the current rate election, the loss-to-the-extent-of-gain rule, and the replacement of the 2016 annual deemed termination election with the annual recognition election. We will then reiterate the need for the angel list election.

The 1991 Proposed Regs; Notice 2000-20

On September 25, 1991, Treasury and the IRS published proposed regulations under section 987.[4] The 1991 proposed regulations provided that section 987 taxable income or loss was to be computed in the QBU's functional currency and then translated into the taxpayer's functional currency at the weighted average exchange rate for the tax year. Thus, under the 1991 proposed regulations, section 987 gain or loss was determined by reference to a taxpayer's entire equity interest in a QBU.[5]

On April 3, 2000, Treasury and the IRS issued Notice 2000-20, 2000-14 IRB 1.[6] The notice expressed concern that the 1991 proposed regulations may not have achieved their goal of providing administrable rules that resulted in foreign currency gain and loss recognition under appropriate circumstances. It also identified abusive transactions that inappropriately accelerated the recognition of section 987 losses.[7]

2006 Proposed Regs and the FEEP Method

On September 7, 2006, Treasury and the IRS withdrew the 1991 proposed regulations and issued new proposed regulations under section 987. To address the concerns related to the 1991 proposed regulations, the 2006 proposed regulations provided a new method for calculating section 987 gains and losses — the FEEP method.

Under the FEEP method, the owner of the QBU determines all items of income, gain, deduction, and loss attributable to the QBU in the QBU's functional currency and then translates those items into the owner's functional currency. For this purpose, the basis of certain assets (historic assets) is translated at the exchange rate for the date on which the assets were acquired.[8]

Other assets (marked assets) are translated into the owner's functional currency at the applicable spot rate. As a result, when translated into the owner's functional currency, the balance sheet value of marked items fluctuates when the

[4] 56 F.R. 48457.

[5] For purposes of determining section 987 gain or loss, taxpayers were required to maintain an equity pool in the QBU's functional currency and a basis pool in the taxpayer's functional currency. The equity and basis pools were increased by the QBU's earnings and capital contributed to the QBU, and were reduced by remittances, losses, and other transfers from the QBU. Taxpayers recognized section 987 gain or loss at the time of a remittance or upon a termination of the QBU. The amount of section 987 gain or loss recognized was equal to the difference between the value of the remittance in taxpayer's functional currency (translated at the applicable spot rate) and the portion of the basis pool attributable to the remittance.

[6] 2001-1 C.B. 851.

[7] *See* the preamble to the 2006 proposed regulations which further states "that the IRS had identified many cases in which taxpayers inappropriately claimed substantial section 987 losses resulting in the application of the 1991 proposed regulations when a QBU's functional currency depreciated relative to the functional currency of its owner."

[8] For example, cost recovery deductions, such as depreciation, for historic assets are translated at the historic rate.

QBU's functional currency strengthens or weakens, but the balance sheet value of historic assets does not.[9]

As a result of the use of a balance sheet approach, together with the use of historic rates for historic items, the FEEP method distinguishes between those items for which value is highly correlated with exchange rates and those items for which exchange rate fluctuations have no effect on value. It was designed to minimizes a taxpayer's ability to recognize large section 987 losses unrelated to its economic exposure and the need for a limitation on the selective recognition of these losses.[10]

There was a hue and cry from all corners of the taxpayer community regarding the FEEP method of the 2006 proposed regulations. The problem was that it required taxpayers to keep a whole new set of books (and potentially obtain new software programs) to keep track of historic items at their historic exchange rates.[11]

2016 Final, Temporary, and Proposed Regs

On December 8, 2016, Treasury and the IRS published final regulations. The 2016 regulations largely adopted the FEEP method contained in the 2006 proposed regulations but modified those regulations to make the FEEP method easier for the IRS to administer and for taxpayers to apply. For example, the 2016 final regulations permit taxpayers to use the yearly average exchange rate (versus the spot rate on the date of acquisition) as the historic rate applicable to historic items.[12]

On the same day, Treasury and the IRS published temporary regulations[13] and a notice of proposed rulemaking by cross-reference to the 2016 temporary regulations.

The 2016 temporary and proposed regulations include:

- rules related to the recognition and deferral of section 987 gain or loss in connection with certain QBU terminations and certain other transactions involving partnerships;
- an annual deemed termination election;
- an elective method (available to taxpayers that make the annual deemed termination election) for translating all items of income or loss related to a section 987 QBU at the yearly average exchange rate;
- rules regarding the treatment of section 988 transactions of a section 987 QBU;
- rules regarding QBUs with the U.S. dollar as functional currency;
- rules regarding combinations and separations of section 987 QBUs;
- rules regarding the translation of income used to pay creditable foreign income taxes;
- rules regarding the allocation of assets and liabilities of certain partnerships for purposes of section 987; and
- rules requiring the deferral of certain section 988 loss that arises with related-party loans.

Under the annual deemed termination election of the 2016 temporary regulations, a taxpayer could elect to deem all of its QBUs to terminate on the last day of each tax year, resulting in the recognition of all net unrecognized section 987 gain or loss on an annual basis.[14] The assets and liabilities of a section 987 QBU subject to the election were deemed to be distributed to the owner under the deemed termination on the last day of each tax

[9] Marked items and historic items are defined by reference to section 988. A marked item is an asset or liability that would generate gain or loss under section 988 if it were held or entered into directly by the owner of the QBU but is not a section 988 transaction regarding the QBU itself. A historic item is an asset or liability that is *not* a marked item. Thus, under the FEEP method, section 987 gain or loss reflects currency fluctuations of marked items, which would be subject to section 988 in the hands of the QBU owner. By contrast, section 987 gain or loss is not imputed to historic items.

[10] The 2006 proposed regulations provided two alternative methods for taxpayers to transition from their prior method of applying section 987: the deferral transition method and the fresh start transition method. Under both transition methods, all the taxpayer's section 987 QBUs were deemed to terminate on the day before the transition date, and the owner was treated as having transferred each section 987 QBU's assets and liabilities to a new section 987 QBU on the transition date. The transition date being defined as the first day of the first tax year to which the 2006 proposed regulations applied to a taxpayer.

[11] *See* the preamble to the 2016 final regulations, stating: "A number of comments suggested that the FEEP method, in particular sections 1.987-3 and -4 of the 2006 proposed regulations, would be difficult to administer." 81 F.R. 88806.

[12] Treas. reg. section 1.097-3(c)(3). Further, the 2016 final regulations required the use of the fresh-start transition method and were generally to apply to tax years beginning on or after one year after the first tax year following December 7, 2016. However, taxpayers could choose to apply them to an earlier year. *See* Treas. reg. section 1.987-11(a) and (b), respectively.

[13] 81 F.R. 88854.

[14] Treas. reg. section 1.987-8T(d).

year and re-contributed on the first day of the following tax year. The 2016 temporary regulations further provided that a taxpayer that made an annual deemed termination election could elect to translate all items of section 987 taxable income or loss at the yearly average exchange rate.[15]

The 2016 temporary regulations (other than those finalized or withdrawn in 2019), expired on December 6, 2019.[16]

The 2019 Final Regulations

On May 13, 2019, Treasury and the IRS published yet another set of section 987 final regulations. The 2019 final regulations finalized parts of the 2016 proposed regulations related to combinations and separations of section 987 QBUs and the recognition and deferral of section 987 gain or loss in connection with certain QBU terminations and certain transactions involving partnerships.[17]

Executive Order 13789 and Interim Report

On April 21, 2017, Executive Order 13789 instructed the Treasury secretary to review all significant tax regulations issued on or after January 1, 2016, and to take action to mitigate the burden of the regulations that, in relevant part, imposed an undue financial burden on U.S. taxpayers or added undue complexity to federal tax laws. The executive order instructed the secretary to submit two reports to the president: an interim report that identified regulations that met the criteria described in the order and a report that recommended specific action to mitigate the burden imposed by regulations identified in the interim report.

On June 22, 2017, Treasury issued its interim report to the president identifying eight regulations, including the 2016 final regulations, as meeting at least one of the criteria set forth in the executive order.[18]

On October 16, 2017, the secretary published a report that recommended specific action to mitigate the burden imposed by regulations identified in the interim report.[19] The report stated that Treasury and the IRS intended to propose changes to the 2016 final regulations and to defer their application. The report stated that in response to comments, Treasury and the IRS intended to propose rules that would permit taxpayers to elect to adopt a simplified method of calculating section 987 gain or loss and translating section 987 taxable income or loss, subject to certain limitations on the recognition of section 987 losses.[20]

The 2023 Proposed Regulations

As noted above, on November 14, 2023, Treasury and the IRS issued the 2023 proposed regulations.

These retain the FEEP method, with modifications, as the default rule[21] and include the 2016 final regulations convention that permits the yearly average exchange rate to be used as the historic rate instead of the historic spot rate when the asset was acquired.

However, Treasury and the IRS acknowledged that it is burdensome to translate the basis of each historic asset using a different historic rate (including for purposes of depreciation). Accordingly, the 2023 proposed regulations provide two simplifying elections — the current rate election and the annual recognition election. That said, the 2023 proposed regulations do not include an election to use the 1991 proposed regulation method.

[15] Treas. reg. section 1.987-3T(d).

[16] The following parts of the 2016 proposed regulations that remain outstanding are: (i) rules regarding the treatment of section 988 transactions of a section 987 QBU; (ii) rules regarding QBUs with the U.S. dollar as their functional currency; (iii) rules regarding the translation of income used to pay creditable foreign income taxes; and (iv) rules requiring the deferral of certain section 988 loss that arises regarding related-party loans.

[17] The 2019 final regulations generally have the same applicability date as the 2016 final regulations.

[18] In Notice 2017-38, 2017-30 IRB 147, Treasury and the IRS requested comments on whether the regulations identified in the interim report (including the 2016 final regulations) should be rescinded or modified and, if not rescinded, how they should be modified to reduce the burden and complexity.

[19] 82 F.R. 48013.

[20] Thereafter, Treasury and the IRS issued several notices that future guidance would defer the applicability dates of the 2016 final regulations and related 2019 final and temporary regulations. *See e.g.*, Notice 2022-34, 2022-34 IRB 150.

[21] *See* Prop. Treas. reg. sections 1.987-3 and 1.987-4.

Current Rate Election and Loss-to-the-Extent-of-Gain Rule

As noted above, under the 2016 final regulations, taxpayers are required to track the historic rate for historic items and to use the historic rate for purposes of computing section 987 tax income or loss and section 987 gain or loss.

To alleviate that compliance burden, the 2023 proposed regulations would provide an election to treat all of a section 987 QBU's items (both historic and marked) as marked items.[22] If elected, all items of income, gain, deduction, and loss regarding a section 987 QBU would be translated at the yearly average exchange rate for purposes of computing section 987 taxable income or loss.[23] In addition, all marked items of the section 987 QBU would be translated at the year-end spot rate for purposes of computing section 987 gain or loss.[24]

That said, without an appropriate limitation, Treasury and the IRS are concerned that the current rate election would facilitate the abuses and inappropriate outcomes that occurred under the 1991 proposed regulations, including the potential for taxpayers to recognize significant and potentially uneconomic section 987 losses while avoiding or deferring section 987 gains. Accordingly, the 2023 proposed regulations include a rule that would suspend the recognition of section 987 loss when a current rate election is in effect.

In a tax year in which a current rate election is in effect, any section 987 loss that would otherwise be recognized as a result of a remittance (including a deemed remittance resulting from the termination of a section 987 QBU) is treated as a "suspended section 987 loss."[25] The owner of a section 987 loss (not the QBU) would recognize the suspended section 987 loss in a tax year in which the owner recognizes section 987 gain that has the same source and character as the suspended section 987 loss (the loss-to-the-extent-of-gain rule).[26] Whether section 987 gain has the same source and character as the suspended section 987 loss would be determined on the basis of the initial assignment.[27]

Finally, a suspended section 987 loss is not recognized when the owner of the section 987 QBU liquidates in a transaction described in section 331.[28] Instead, the suspended section 987 loss that is not recognized in the tax year of the liquidation is eliminated and is never recognized.[29]

Annual Recognition Election Replaces Annual Deemed Termination Election

As noted above, the 2016 temporary and proposed regulations contained an annual deemed termination election. Under this election, a section 987 QBU would be deemed to terminate on the last day of each tax year, resulting in the remittance of all of its gross assets to its owner and recognition of all net unrecognized gain or loss on an annual basis.[30] The assets and liabilities of a section 987 QBU subject to this election would then be deemed to be re-contributed to the section 987 QBU on the first day of the following tax year.[31]

The 2023 proposed regulations would replace the annual deemed termination election with an annual recognition election. Like the annual deemed termination election, an owner that makes the annual recognition election would recognize the full amount of net unrecognized section 987 gain or loss each year. However, the proposed annual recognition election does not

[22] Prop. Treas. reg. section 1.987-1(d)(2).

[23] Prop. Treas. reg. section 1.987-3(c).

[24] *See* the Preamble to the 2023 proposed regulations. 88 F.R. 78134. Treasury and the IRS believe that the use of a current rate election will be closely equivalent to that achieved under financial accounting principles and the 1991 proposed regulations. *See* Preamble.

[25] Prop. Treas. reg. section 1.987-11(c).

[26] Prop. Treas. reg. section 1.987-11(e).

[27] *See* Prop. Treas. reg. sections 1.987-6(b)(2)(i) and 1.987-11(e)(1) and (f). The proposed regulations provide rules related to suspended section 987 loss recognized or attributed to a successor on the termination of the QBU that gave rise to the loss. *See* Prop. Treas. reg. section 1.987-13.

[28] Prop. Treas. reg. section 1.987-13(f). This rule is intended to prevent taxpayers from entering into section 331 transactions in order to trigger the recognition of a suspended section 987 loss. For example, a U.S. shareholder could cause an upper-tier controlled foreign corporation that owns a section 987 QBU with a suspended section 987 loss to transfer all its assets and liabilities to a lower-tier CFC in a section 351 contribution and then cause the upper-tier CFC to liquidate, in a transaction described in section 331, in order to recognize the suspended loss. Treasury and the IRS are aware that similar transactions have been used to claim large section 987 losses under current law.

[29] *Id.*

[30] Treas. reg. section 1.987-8T(d).

[31] Treas. reg. section 1.987-8T(d).

result in a deemed termination of a section 987 QBU and a deemed remittance of its assets, or a deemed contribution to the section 987 QBU. Instead, the owner of a section 987 QBU simply recognizes the full amount of its net unrecognized section 987 gain or loss on an annual basis. Therefore, the annual recognition election would not alter the functional currency basis of a section 987 QBU's assets, the amount of its liabilities, or their historic exchange rates.

Current Rate Election and Annual Recognition Election

The annual recognition election is available to owners whether or not they make a current rate election. If an owner makes both an annual recognition election and a current rate election for a tax year, the loss suspension rule does not apply to net unrecognized section 987 losses accrued while the election is in effect.[32] Because the annual recognition election requires both gains and losses to be recognized without regard to whether a remittance occurs, selective recognition of losses is not possible and, accordingly, a loss limitation is not needed.

Annual Recognition Election Without Current Rate Election

If an owner of a section 987 QBU makes an annual recognition election but does not make a current rate election, the owner would use the yearly average exchange rate for purposes of determining section 987 taxable income or loss.[33] However, the owner would use historic rates to translate historic items for purposes of determining section 987 gain or loss.[34] Thus the same historic item would be translated at different exchange rates for different purposes. Under the mechanics of the FEEP method, if a historic asset is sold or depreciated during the tax year, the difference between the historic rate basis and the current average rate basis would be added to the pool of unrecognized section 987 gain or loss (and recognized under the annual recognition election).

[32] Prop. Treas. reg. section 1.987-1(c)

[33] *See* the Preamble to the 2023 proposed regulations. 88 F.R. 78134.

[34] *Id.*

Transition Rules

As noted above, the 2016 final regulations require all owners of section 987 QBUs to apply the fresh start transition method. Under this method, unrecognized section 987 gain or loss determined for years before the transition date generally would not be taken into account under section 987. In addition, for purposes of applying the FEEP method in the first year in which the regulations apply, the assets and liabilities of the section 987 QBU must be translated using historic rates.

New transition rules are suggested by the 2023 proposed regulations. These would apply in the tax year beginning on the transition date (the first day of the first tax year in which the regulations apply). For purposes of determining unrecognized section 987 gain or loss, the assets and liabilities reflected on a section 987 QBU's balance sheet at the end of the previous year would be translated into the owner's functional currency at the spot rate on the day before the transition date.[35] Similarly, for taxpayers that do not make a current rate election, the historic rate for historic assets and liabilities would generally be the spot rate on the day before the transition date.[36] These rules are intended to simplify the application of the FEEP method by eliminating the need to determine actual historic rates in the first tax year in which the regulations apply.

Under the 2023 proposed regulations, an owner of a section 987 QBU must determine the amount of section 987 gain or loss that has accrued before the transition date.[37] By default, in the first tax year in which the regulations apply, pre-transition gain is treated as net unrecognized section 987 gain, and pre-transition loss is treated as suspended section 987 loss.[38] Alternatively, taxpayers can elect to amortize pre-transition gain

[35] Prop. Treas. reg. section 1.987-10(d)(1).

[36] Prop. Treas. reg. section 1.987-10(d)(2).

[37] Prop. Treas. reg. section 1.987-10(e).

[38] Prop. Treas. reg. section 1.987-10(e)(5)(i). This proposed rule is intended to prevent taxpayers from selectively recognizing pre-transition loss while deferring pre-transition gain until a remittance.

or loss over a period of ten years beginning on the transition date.[39]

The 'Angel List' Election

As noted above, on November 14, 2023, Treasury and the IRS issued the 2023 proposed regulations. These seek to simplify the required section 987 computations under the FEEP method with:

- an election to treat all items of a QBU as marked items subject to a loss suspension rule (the current rate election and the loss-to-the-extent-of-gain rule); and
- an election to recognize all foreign currency gain or loss for a QBU on an annual basis (the annual recognition election), which has replaced the annual deemed termination election of the 2016 temporary and proposed regulations.

To return to our opening proposition, an election is still needed to exclude from the definition of historic asset and from section 987 computations completely all assets that do not contribute to the competitive advantages, core capabilities, or fundamental risks of success or failure in one or more of a taxpayer's trades or businesses — *et voilà*, the angel list election. The effect on federal revenue should be modest at most, and the benefits of which to both tax administration and taxpayer should be immediately obvious. ■

[39] Prop. Treas. reg. section 1.987-10(e)(5)(ii). In order to prevent owners subject to this election from offshoring pre-transition gain or importing pre-transition loss, the proposed regulations provide that, immediately before an inbound or outbound transaction, any unrecognized pre-transition gain is recognized and any pre-transition loss is suspended. As a result, the suspended section 987 loss may be recognized subject to the loss-to-the-extent-of-gain rule. In the case of an inbound transaction of a foreign owner with pre-transition loss, any suspended section 987 loss that is not recognized before the transaction would not carry over to the domestic acquiring corporation. *See* Prop. Treas. reg. sections 1.987-10(e)(5)(ii)(B) and 1.987-13(g), respectively.

Once finalized, the regulations (and the parts of the 2016 final regulations that are not replaced or modified by the 2023 proposed regulations) would apply to tax years beginning after December 31. Prop. Treas. reg. section 1.987-14(a)(1).