# Section 987 Practice Unit Reflects a Permissive Attitude Towards Different Methods of Branch Currency Translation



A few weeks ago, the IRS released a new "practice unit" providing training for its examiners on translation of foreign currency gains and losses of branches (so-called qualified business units, or QBU) under §987.[1] Interestingly, despite the hundreds of pages of proposed and final regulations that have been issued on this subject since 2006, the practice unit boils down §987 to a few key takeaways reflected on approximately 10 slides. Noticeably absent from the practice unit is any detailed training on the complex calculations required under the final 2016 regulations (that are currently and temporarily suspended).

After describing the concept of a branch, or QBU, that operates in a different functional currency, the practice unit notes that taxpayers commonly employ several methods of computing §987 consequences of operating through a QBU:

1. The profit and loss method, as set out in the now-withdrawn 1991 proposed regulations
2. The "earnings only" variation of the profit and loss method
3. The original Foreign Exchange Exposure Pool ("FEEP") method set out in the 2006 proposed regulations
4. The modified FEEP method that was incorporated in the final regulations issued in 2016, which are currently suspended until at least 2022 for calendar-year taxpayers -- *see* IRS Notice 2020-73

The actual operation of these methods is summarized in a single slide with a brief conceptual description of the method. There is no detailed walk-through of the method currently reflected in the 2016 final regulations, which the practice unit treats as just one of several commonly employed methods for applying a statute in need of practical interpretation. Perhaps this is a tacit acknowledgment by the IRS that the profit and loss method (or earnings only variation) remains an equally viable method under the statute and legislative history.[2]

## Gain and Loss Deferral Rules

Importantly, the practice unit reminds IRS examiners that the final regulations include immediately operative gain and loss deferral rules. Regardless of the method chosen to apply §987, these deferral rules apply to prevent certain intragroup transfers of QBUs from triggering §987 gains, and more importantly from the IRS and Treasury's perspective, losses.

Since the original 2000 guidance project reconsidering the 1991 proposed regulations, preventing the selective recognition of §987 losses has long been a major goal of the IRS and Treasury in implementing §987.

The deferral rules are found in Treas. Reg. §1.987-12. As explained by the practice unit, the concept of the "[deferral] rules were established to defer §987 losses when there was a continuity of ownership of the QBU within a single controlled group." The deferral rules contain two parts: one set of rules which defers both gains and losses on what might be termed technical terminations of a QBU and a separate set of "outbound loss events" that prevents the outbound transfer of a QBU from the U.S. parent to a controlled foreign corporation (CFC) in a transaction governed by §367 from triggering §987 loss.

Under the first set of rules, neither §987 gain nor loss is currently recognized on certain terminations of a QBU. Specifically, deferral events include the termination of a QBU arising from events *other than* those due to cessation of the QBU's business (i.e., a winding up of a QBU), a foreign corporation owner of the QBU ceasing to be a CFC, or certain mergers or liquidations involving CFCs in which the QBU is transferred to a CFC with the same functional currency as the QBU. (The events excepted from the deferral rule all represent situations in which the controlled group's owning economic exposure to the branch's functional currency investment is effectively terminated.)

In addition, for gain or loss to be deferred, the QBU's trade or business must be conducted by a valid "successor QBU." The successor QBU is defined as a QBU in the same controlled group and which QBU, if the original QBU was held by a U.S. person, is also owned by a U.S. person.

The rationale of these rules is to prevent internal transactions within the U.S. or CFC groups from triggering §987 gain or loss where another member of the group retains the exposure to the QBU's gains or losses. The deferral of gains and losses, however, is limited under a "water's edge" principle: gains are deferred only on transfers of a QBU between members of the U.S. group or between different CFCs (none of which has the same functional currency as the QBU). If the QBU crosses a border from the U.S. to foreign ownership, however, §987 gains would currently be recognized.

A separate rule of which the practice unit reminds examiners defers recognition of §987 loss on an "outbound loss deferral" event. On such a transfer, which would include an outbound transfer of a QBU to a foreign corporation, the §987 loss is deferred and added to the transferor's basis in the transferee's stock.

## What Can we Glean from the Practice Unit?

The practice unit first serves as a reminder that, no matter what method a taxpayer may be using for purposes of applying §987, the IRS remains leery of taxpayers' recognition of §987 loss particularly on internal restructuring transactions. The outbound loss deferral events and other more general deferral rules are currently in effect and the practice unit reminds examiners to apply those rules where it is appropriate to do so.

Second, the practice unit shows that the IRS's own training materials do not, as of yet, include a detailed walk-through of the mechanics of the modified and detailed §987 method set out in the current final (yet temporarily suspended) 2016 regulations. This may foretell that the 2016 final regulations will continue to be suspended for the near future and/or that the IRS acknowledges that the 2016 final regulations are overly complex to be administered by its own compliance team. For now, at least, it would appear that the IRS acknowledges that any of the several "commonly employed" methods described in the slides is permissible. The statement from the U.S. Tax Court 70 years ago on this subject would still seem to be true today—that "a consistent method of accounting in a regularized and continuous business operation will succeed in reflecting income to a sufficiently accurate degree for Federal income tax purposes."[3]

2. See §987(1) and (2) and 1986 Blue Book, p. 1109. See also House Report No. 99-426, 1986-3 C.B. Vol. 2 at 479; Senate Report No. 99-313, 1986-3 C.B. Vol. 3 at 470. ↩

3. *American Pad & Textile Co. v. Commissioner*, 16 T.C. 1304, 1311 (1951)↩

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