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## US International Tax Course

August 11-15, 2025 | Atlanta, GA

# Foreign Currency Issues Including Section 987

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# Speakers



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# Agenda

- Overview of currency rules
- Qualified business unit (QBU) – Section 989
- Determining functional currency – Section 985
- Transactional foreign exchange (FX) – Section 988
- FX on previously taxed E&P (PTEP) distribution – Section 986(c)
- Translational foreign exchange – Section 987



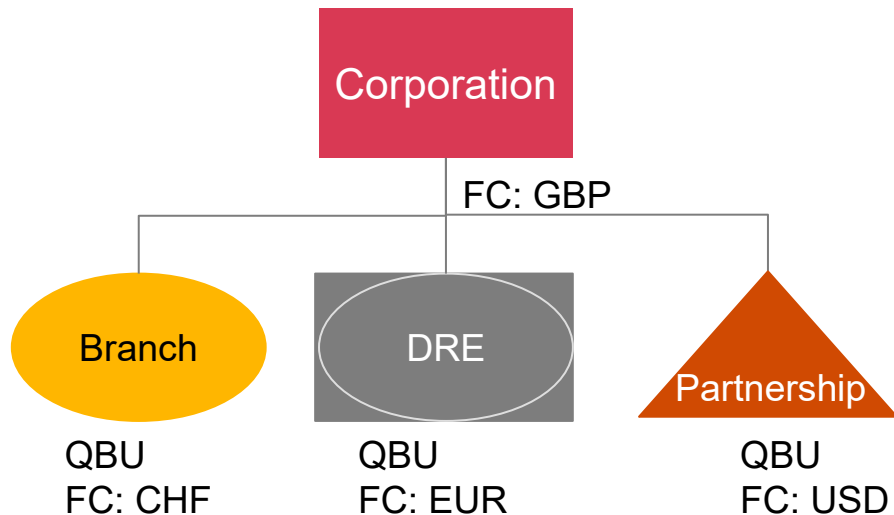
# Overview of currency rules

	Section 989	Section 985	Section 986(c)	Section 987	Section 988
What	Defines a QBU	Functional currency rules	Foreign currency gain or loss with respect to distributions of previously taxed earnings and profits (PTEP)	Operations in a foreign currency in flow-through entities	Defines certain transactions that give rise to foreign currency gain/loss
Impact	QBUs may have foreign currency gains / losses from Section 988 transactions denominated in a nonfunctional currency of the QBU and give rise to Section 987 gain / loss when operating in a different functional currency than its owner	<p>Determines items / entities subject to foreign currency rules</p> <p>Entities that change their functional currency under Section 985 may need to recognize foreign currency gains or losses</p>	A US shareholder may have a foreign currency gain / loss under Section 986(c)	Non-corporate (branch, DRE, partnership) QBUs may have a foreign currency gain / loss under Section 987 whenever remittances are made by the QBUs to its owner	Provides character, source, and certain timing rules applicable to Section 988 transactions

# Qualified business unit – Section 989



# Qualified business unit (QBU) – Section 989



- Any **separate and clearly identified** unit of a **trade or business** of a taxpayer which **maintains separate books and records**
  - See Section 989(a) and Treas. Reg. sec. 1.989(a)-1(b)
- Two part test
  - It must have activities that constitute a **‘trade or business’**
    - Specific unified group of activities that constitute an independent economic enterprise carried on for profit
    - Whether a trade or business exists is a facts and circumstances test (See Treas. Reg. sec. 1.989(a)-1(c))
  - Maintain a **separate set of books and records** with respect to such trade or business (See Treas. Reg. sec. 1.989(a)-1(d))
- Certain entities are *per se* QBUs based on their US tax classification (e.g., corporations, certain partnerships, etc.)
- QBUs may be different legal types, both corporate and non-corporate
- The functional currency of a QBU may not be the currency of the country in which the QBU is located (See Section 985)

# Determining functional currency – Section 985

# Functional currency – Overview

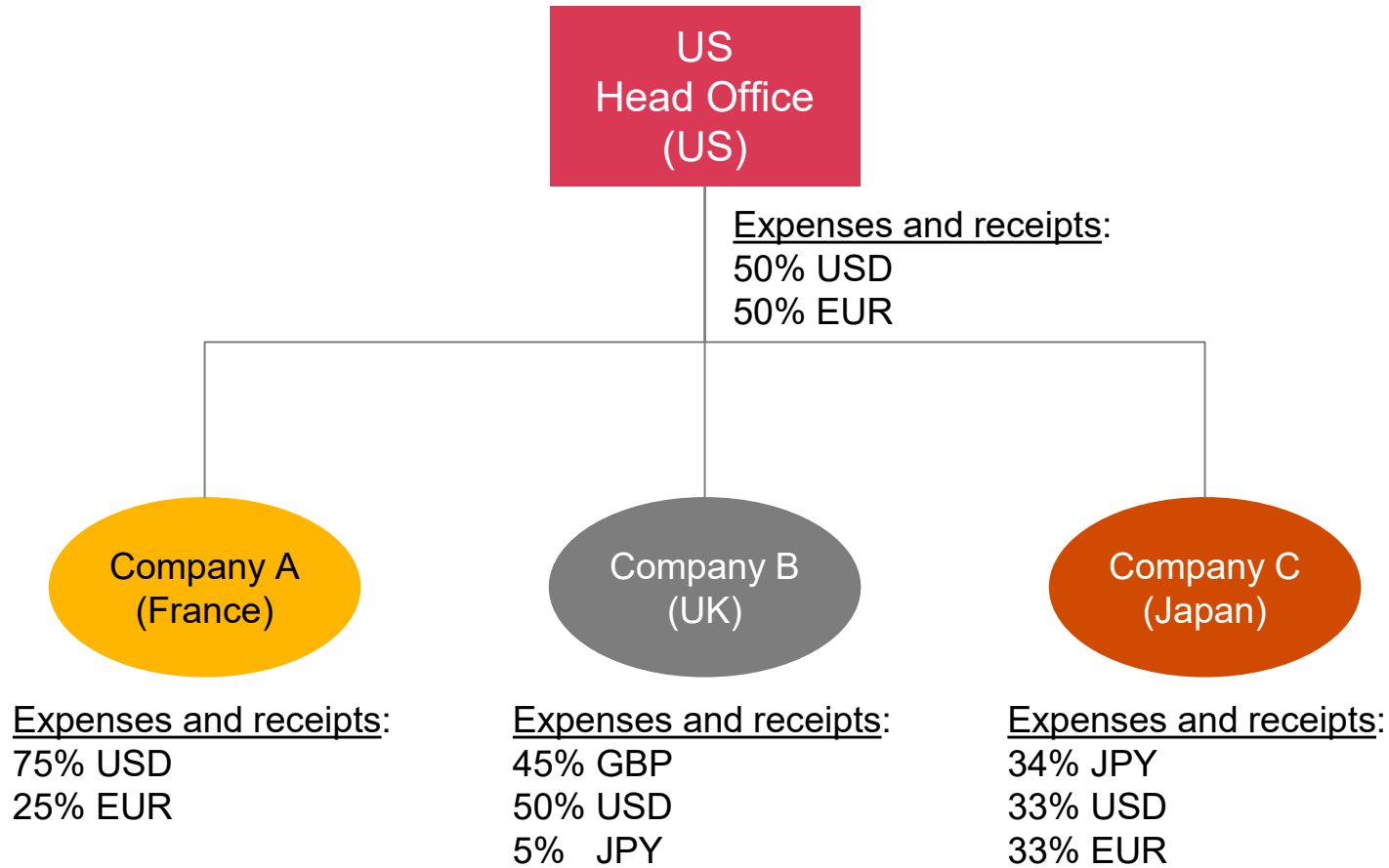
- All determinations for US Federal income tax purposes **must** be made in the QBU's functional currency
  - Determining taxable income
  - Determining earnings and profits
  - Foreign tax credits, etc.
- Transactions **not** denominated in the QBU's functional currency generally produce foreign exchange (FX) gain or loss
- Section 985 determines a QBU's functional currency



# Functional currency – Choosing a functional currency

US citizens, residents, and persons	All other persons
<ul style="list-style-type: none"><li>• In general, functional currency for all QBUs that have the US as its residence (e.g., domestic corporations, domestic partnerships, etc.) is the <b>US dollar</b></li></ul>	<ul style="list-style-type: none"><li>• Subject to limited exceptions, functional currency is the currency of the economic environment in which a <b>significant part of the activities are conducted and which is used to keep the books</b></li><li>• Factors to consider under Treas. Reg. sec. 1.985-1(c)(2):<ul style="list-style-type: none"><li>○ Residency</li><li>○ Cash flows</li><li>○ Currency of sales markets</li><li>○ Currency in which pricing / financial decisions are made</li><li>○ Duration of business operations</li><li>○ Significance / volume of independent activities</li><li>○ US GAAP – See Treas. Reg. sec. 1.985-1(c)(5)</li></ul></li><li>• If taxpayer has multiple currencies that could be its functional currency, the taxpayer can choose its functional currency</li></ul>

# Functional currency – Example



Functional currency	
US Head Office	USD
Company A	USD
Company B	GBP or USD?
Company C	JPY, USD, or EUR?

# DASTM– Overview

- QBUs whose functional currency is a hyperinflationary foreign currency are required to use the dollar approximate separate transactions method (“DASTM”) method of accounting.
  - The DASTM method of accounting generally requires the business unit to change its functional currency to the USD (special rule if owned by a non-USD CFC).
  - Generally, such a change is automatic and does not require the filing of a Form 3115. Importantly, adjustments under the transition rules are required under Treas. Reg. sec. 1.985-7
- Current hyperinflationary currencies include:
  - Argentinian peso
  - Venezuelan bolivar
  - Turkish lira

# Change in Functional Currency

- Generally, taxpayer must file a Form 3115 and the change is effective the beginning of the tax year
- Adjustments required as of the last day of the taxable year ending *before* the year of the change under. Treas. Reg. sec. 1.985-5.
  - *Step 1* – MTM section 988 transactions denominated in the new functional currency. Treas. Reg. sec. 1.985-5(b).
  - *Step 2* – Translate bases in QBU's assets and liabilities to its new functional currency using the spot exchange rate on the last day of the taxable year ending before the year of the change. Treas. Reg. sec. 1.985-5(c).
  - *Step 3A* – Terminate or create section 987 QBUs (discussed later) or translate existing section 987 QBUs basis pool on the last day of the taxable year ending before the year of change. Treas. Reg. sec. 1.985-5(d)(2).
  - *Step 3B* – If a corporation changes its functional currency:
    - The corporation's E&P is translated at the spot rate on the last day of the taxable year ending before the year of change. Treas. Reg. sec. 1.985-5(e)(1).
    - A U.S. shareholder of a CFC that changes the CFC's functional currency to USD must recognize foreign currency gain or loss under section 986(c) as if all PTEP were distributed immediately prior to the change. Treas. Reg. sec. 1.985-5(e)(2).

# Change in Functional Currency – Special Rule

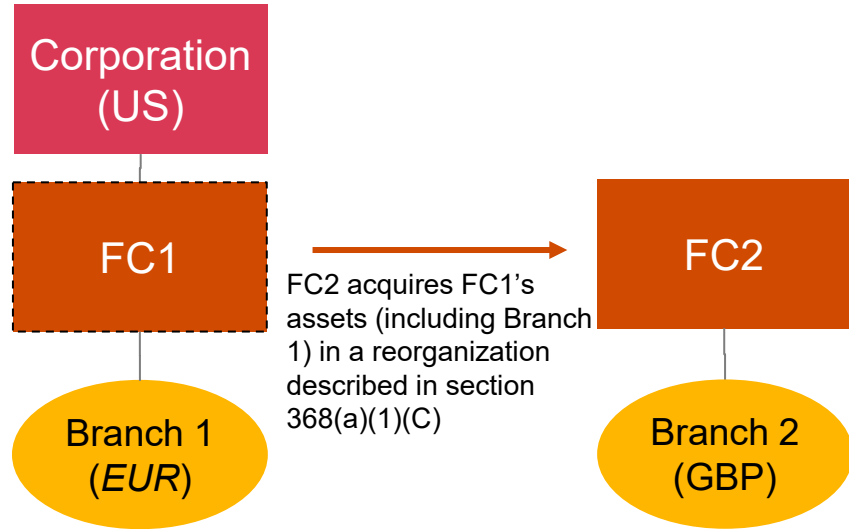
Treas. Reg. sec. 1.367(b)-2(j)(1)(i)

- If, as a result of a *section 367(b) exchange* described in section 381(a), a *QBU* (as defined in section 989(a)) has a *different functional currency* determined under the rules of section 985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction
- Must make the adjustments described in Treas. Reg. sec. 1.985-5 immediately before the transaction
- No Form 3115 required

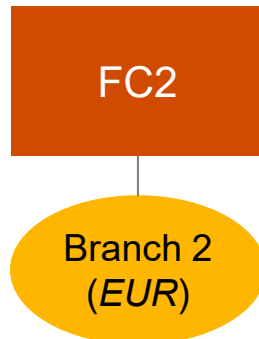


# Treas. Reg. sec. 1.367(b)-2(j)(1)(ii) – Example

## Merger



## Resulting Structure



## Facts

- DC, a domestic corporation, owns 100 percent of FC1, a foreign corporation. FC1 owns and operates a QBU (B1) in France, whose functional currency is the EUR.
- FC2, an unrelated foreign corporation, owns and operates a QBU (B2) in France, whose functional currency is the GBP.
- FC2 acquires FC1's assets (including B1) in a reorganization described in section 368(a)(1)(C).
- As a part of the reorganization, B1 and B2 combine their operations into one QBU.
- Applying the rules of section 985(b), the functional currency of the combined operations of B1 and B2 is the EUR.

## Discussion

FC2's acquisition of FC1's assets is a section 367(b) exchange that is described in section 381(a):

- Because the functional currency of the combined operations of B1 and B2 after the exchange is the EUR, B2 is deemed to have automatically changed its functional currency to the EUR immediately prior to the section 367(b) exchange.
- B2 must make the adjustments described in Treas. Reg. sec. 1.985-5.

# Transactional FX – Section 988

# Section 988 – Key Principles

Nonfunctional currency is property



Taxpayers have a cost basis in their nonfunctional currency  
(and nonfunctional-currency-denominated transactions)



Disposition of the nonfunctional currency (or non-functional-currency-denominated transaction)  
triggers FX gain or loss based on currency movements. See Treas. Reg. sec. 1.988–2

# Section 988 – Overview

<b>Who?</b>	<ul style="list-style-type: none"><li>• US corporations and QBUs</li></ul>
<b>What?</b>	<ul style="list-style-type: none"><li>• Certain identified transactions denominated in / determined by reference to nonfunctional currency</li></ul>
<b>Character?</b>	<ul style="list-style-type: none"><li>• Generally ordinary income</li></ul>
<b>When?</b>	<ul style="list-style-type: none"><li>• General tax principles of income recognition apply (Sections 1001, 1256, etc.), unless a 'last clear chance' timing rule applies (e.g., Treas. Reg. sec. 1.988-2(b)(13))</li></ul>
<b>Source?</b>	<ul style="list-style-type: none"><li>• Generally sourced by reference to residence of taxpayer or QBU</li></ul>

# Section 988 transactions

## FX payables / receivables



- FX gains and losses from payables and receivables

## FX debt instruments



- Debt instruments denominated in nonfunctional currency

## FX derivatives



- Forwards, futures, option or swap contracts to buy, sell or exchange nonfunctional currency
  - The underlying asset must be nonfunctional currency

## FX cash



- Gains and losses from dispositions of nonfunctional currency
  - Certain 'personal transactions' are not subject to Section 988

- Stock is NOT a section 988 transaction
- Section 988 loss is a reportable transaction unless it qualifies for an exception



# Section 988 – Payables and receivables example



- Day 1 - The payable is worth \$100 ( $€100 \times 1 = \$100$ )
- Day 60 - The payable is worth \$110 ( $€100 \times 1.1 = \$110$ )

## Example

### Background

- US Buyer is a US resident with the US dollar as its functional currency
- US Buyer purchases inventory from Vendor and agrees to pay €100 in 60 days; inventory is delivered on day 1
  - Day 1 - the exchange rate of EUR:USD is 1:1
  - Day 60 - the exchange rate of EUR:USD is 1:1.1

### Questions

1. Is this a Section 988 transaction? If so, why?
2. What is the amount of potential Section 988 gain or loss?
3. When does US Buyer realize a Section 988 gain or loss?
4. What is the character of such a Section 988 gain or loss (if any)?
5. What is the source of any Section 988 gain or loss (US source or foreign source)?

# Section 988 – Payables and receivables (continued)



- Day 1 - The payable is worth is \$100 ( $€100 \times 1 = \$100$ )
- Day 60 - The payable is worth is \$110 ( $€100 \times 1.1 = \$110$ )

## Example (continued)

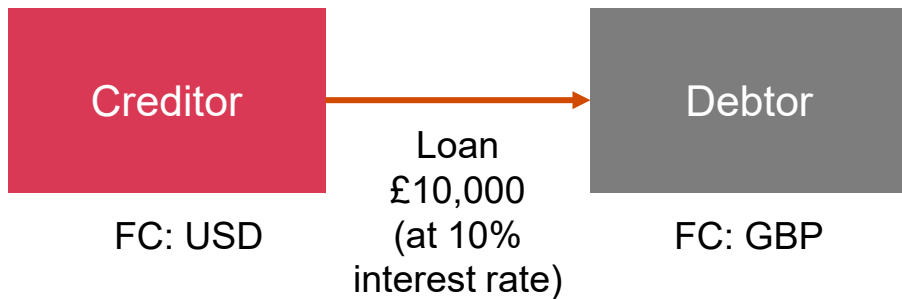
### Analysis

1. Is this a **Section 988 transaction**?
  - US Buyer **entering into the payable is** a Section 988 transaction
  - The **purchase of inventory itself is not** a Section 988 transaction
  - See Treas. Reg. sec. 1.988-1(a)(1)(ii) and (2)(ii)
1. What is the **amount of** potential Section 988 gain or loss?
  - Section 988 **loss of \$10** (booked \$100 but paid \$110)
1. **When** does US Buyer **realize** a Section 988 gain or loss?
  - When US Buyer **pays the payable**
    - i. See Treas. Reg. sec. 1.988-2(c), -1(d)(3)
1. What is the **character** of such a Section 988 gain or loss (if any)?
  - **Ordinary** - See Treas. Reg. sec. 1.988-3(a)
1. What is the **source** of any Section 988 gain or loss (US or foreign)?
  - **US source** as US Buyer is a US resident (See Treas. Reg. sec. 1.988-4)

# Section 988 – FX debt instruments

FX gain or loss from the payment of <b>PRINCIPAL</b>	FX gain or loss from the payment of <b>INTEREST</b>	Gain or loss from the <b>DISPOSITION</b> of the debt instrument
<ul style="list-style-type: none"> <li>The amount of FX gain or loss is determined by comparing:               <ul style="list-style-type: none"> <li>the <b>issue / acquisition date spot rate</b> to</li> <li>the <b>settlement date spot rate</b></li> </ul> </li> <li>See Treas. Reg. 1.988-2(b)(5) and (6)</li> </ul>	<ul style="list-style-type: none"> <li>For <b>accrual taxpayers</b>, the amount of FX gain or loss is determined by comparing:               <ul style="list-style-type: none"> <li>the <b>spot rate on interest payment date</b> to</li> <li>the <b>average rate for the respective accrual period</b></li> <li>See Treas. Reg. sec. 1.988-2(b)(3) and (4)</li> </ul> </li> <li>A taxpayer may elect to accrue interest at the spot rate for the last day of the accrual period (i.e., spot rate election under Treas. Reg. sec. 1.988-2(b)(2)(iii)(B))               <ul style="list-style-type: none"> <li>A spot rate election may create a mismatch between book and tax</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li><b>FX</b> component is <b>computed separately</b> from the debt holder's <b>gain or loss on the overall disposition</b> transaction</li> <li><b>Netting rule</b> - If there is gain or loss on the overall disposition transaction as well as offsetting FX loss or gain, the two components should be netted (Treas. Reg. sec. 1.988-2(b)(8))               <ul style="list-style-type: none"> <li>Step 1: Calculate the exchange gain or loss</li> <li>Step 2: Calculate the total overall gain or loss on the transaction</li> <li>Step 3: Compare the amounts. Exchange gain or loss should be recognized only to the extent of the total overall gain or loss</li> </ul> </li> </ul>

# Section 988 – FX debt instruments example



## Example

### Background

- Creditor is on the accrual method of accounting with USD as its functional currency
- On January 1, Year 1, Creditor converts \$13,000 to £10,000 at a GBP:USD spot rate of 1:1.3 and loans the £10,000 to Debtor at a 10% annual interest rate
- Debtor makes **interest** payments of £1k on December 31 of Years 1-3
- Debtor repays the £10,000 **principal** on December 31 of Year 3
- The relevant GBP:USD spot rates and average rates are as follows:

Spot rates		Average rates	
January 1, Year 1	£1:\$1.3		
December 31, Year 1	£1:\$1.35	Year 1	£1:\$1.32
December 31, Year 2	£1:\$1.4	Year 2	£1:\$1.37
December 31, Year 3	£1:\$1.45	Year 3	£1:\$1.42

# Section 988 – FX debt instruments example (continued)

## Analysis

### Principal

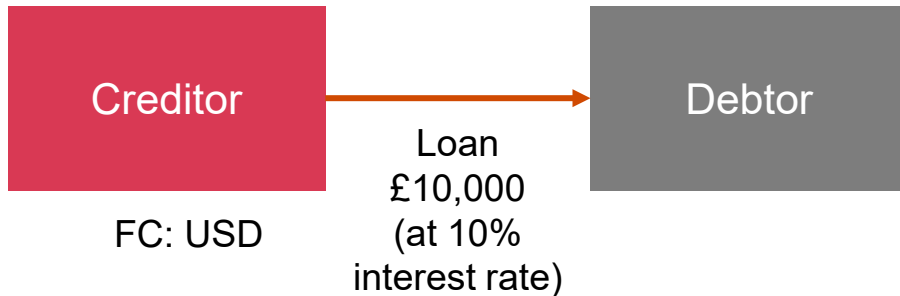
- Creditor will realize a \$1,500 FX gain on the repayment of the £10,000 principal amount
  - **Spot rate of the repayment date** = Year 3, Dec. 31 = £1:\$1.45
    - $£10,000 \times \$1.45 = \$14,500$
  - **Spot rate of the issuance date** = Jan 1, Year 1 = £1:\$1.3
    - $£10,000 \times \$1.3 = \$13,000$
  - **Section 988 gain** =  $\$14,500 - \$13,000 = \$1,500$

### Interest

- Creditor is an accrual basis taxpayer; for each accrual period compare:
- Interest income received at the **spot rate on the date received**, minus
- Interest income received at the **average rate** for each **accrual** period

	Spot rate		Average rate		G/L
Year 1	£1:\$1.35	\$1,350	£1:\$1.32	\$1,320	\$30
Year 2	£1:\$1.4	\$1,400	£1:\$1.37	\$1,370	\$30
Year 3	£1:\$1.45	\$1,450	£1:\$1.42	\$1,420	\$30

- Thus, Creditor will **realize** \$90 of exchange gain with respect to interest received under the loan





# Section 988 – Derivatives

- A Section 988 transaction generally includes entering into or acquiring any **forward contract, futures contract, option, or similar financial instrument**
  - A Section 988 transaction **does not include** a regulated futures contract or an exchange traded currency option that would be marked to market under Section 1256 unless an affirmative election is made to apply Section 988
  - A Section 988 transaction **does not include** a transaction in which the **underlying property** to which the instrument ultimately relates **is other than nonfunctional currency**

Outside Section 988	Covered by Section 988
<ul style="list-style-type: none"><li>• Forward contract to purchase wheat in a nonfunctional currency</li><li>• Option to enter into a forward contract to purchase wheat in a nonfunctional currency</li><li>• Warrant to purchase stock in a nonfunctional currency</li></ul>	<ul style="list-style-type: none"><li>• Forward contract to purchase or sell a nonfunctional currency</li><li>• Option to enter into a forward contract to purchase a nonfunctional currency</li><li>• Option to purchase a bond denominated in or the payments of which are determined by reference to a nonfunctional currency</li><li>• Notional principal contracts where the payments are in a nonfunctional currency or determined by reference to a nonfunctional currency</li></ul>

## Section 988 – Derivatives (continued)

- FX gain or loss with respect to forward contracts, futures contracts and option contracts is determined by comparing:
  - **Amount received** (or deemed received), if any, for or with respect to the contract; to
  - **Amount paid** (or deemed paid), if any, for or with respect to the contract
- If the taxpayer **makes or takes delivery** in connection with a forward, futures or option contract
  - Any **gain or loss is recognized** in the **same manner** as if the taxpayer sold the contract on the date on which it took or made delivery for its fair market value on such date
- Special rules for computing FX gain or loss with respect to currency swaps. See Treas. Reg. sec. 1.988-2(e)

# Section 988 – Subpart F

- **Net FX gains** are generally foreign personal holding company income (FPHCI)
  - Absent election, **net FX losses do not offset** other categories of FPHCI
- FX gains and losses on **interest-bearing liabilities** are characterized as subpart F and non-subpart F income in the same manner in which interest expense is **allocated and apportioned**
- FX gain or loss is excluded from current subpart F income if either:

Business needs exception	Bona fide hedging transactions
<ul style="list-style-type: none"><li>• FX gain/loss arises from:<ul style="list-style-type: none"><li>○ A transaction occurring in the normal course of trade or business;</li><li>○ A transaction that does not (or is not reasonably expected to) give rise to subpart F income (other than FX income); and</li><li>○ A transaction that is not itself a currency derivative</li></ul></li></ul>	<ul style="list-style-type: none"><li>• FX gain/loss arises from a properly identified hedging transaction that hedges a transaction or property that satisfies the conditions of the business needs exception</li><li>• Standard generally based on the Section 1221 standard for “hedging,” but expanded upon for subpart F purposes</li><li>• Proper identification is required!</li></ul>
<ul style="list-style-type: none"><li>• Special pro rata rules for FX gains and losses arising from a transaction that gives rise to both non-subpart F income and subpart F income or from a bona fide hedging transaction with respect to such a transaction. Prop. Reg. sec. 1.954-2(g)(2)(ii)(C)</li></ul>	

## Section 988 – Subpart F (continued)

- As noted on prior slide, **net FX gains** are generally FPHCI and, absent an election, **net FX losses do not offset** other categories of FPHCI.
- Election under Treas. Reg. sec. 1.954-2(g)(4): Upon election of controlling US shareholders, a CFC includes in FPHCI net FX gains or net FX losses.
  - Upside: Any net FX losses offset other categories of FPHCI.
  - Downside: all net FX gain or loss is included in FPHCI; turns off the business needs exception.
- Election under Treas. Reg. sec. 1.954-2(g)(3): Upon election of controlling US shareholders, net FX gain or loss otherwise includible in a CFC's FPHCI is included in the category (or categories) of subpart F income to which such gain or loss relates (e.g., foreign base company sales/services income, dividends, interest, rents, royalties, annuities).
- The controlling US shareholders make the (g)(3) and (g)(4) elections by filing a statement with their original income tax returns and can revoke such elections on original or amended tax returns.

# FX on PTEP distribution – Section 986(c)

# Section 986(c) – Overview

<b>Who?</b>	<ul style="list-style-type: none"><li>• A US shareholder of a controlled foreign corporation (CFC)</li></ul>
<b>What happens?</b>	<ul style="list-style-type: none"><li>• Gain or loss recognized by the US shareholder on the distribution of PTEP due to FX rate fluctuations between:<ul style="list-style-type: none"><li>◦ the date of the deemed income inclusion; and</li><li>◦ when PTEP is actually distributed (or deemed distributed)</li></ul></li></ul>
<b>Character?</b>	<ul style="list-style-type: none"><li>• Ordinary income or loss</li></ul>
<b>When?</b>	<ul style="list-style-type: none"><li>• Tax year in which PTEP is actually distributed (or deemed distributed)</li></ul>
<b>Source?</b>	<ul style="list-style-type: none"><li>• The same source as the associated income inclusion</li></ul>

# Section 986(c) – Section 986(c) gain or loss

## Determination of Section 986(c) gain or loss

- Section 986(c) gain or loss is determined by comparing:
  - PTEP distribution in USD; to
  - Basis of PTEP in USD

PTEP distribution (in USD)	<ul style="list-style-type: none"><li>• Translate PTEP <b>distribution amount</b> at <b>spot rate on distribution date</b> into the owner’s functional currency</li></ul>
Basis of PTEP (in USD) by layer	$= \frac{\text{Local currency (LC) PTEP distribution}}{\text{LC PTEP Pool before distribution}} \times \text{USD PTEP Pool before distribution}$

# Section 986(c) – PTEP distributions

## Order of PTEP Distributions

General	Notice 2019-01 (in general)
Section 959(c)(1) - E&P attributable to amounts included in gross income under Sections 951(a)(1)(B) and 951(a)(1)(C) (e.g., PTEP from investments in US property)	Track PTEP groups by Section 904 basket
Section 959(c)(2) - E&P attributable to amounts included in gross income under Section 951(a)(1)(A) (e.g., PTEP from subpart F income, GILTI, Section 965 transition tax inclusions)	Priority for Section 965(a) and Section 965(b)
Section 959(c)(3) - other E&P (e.g. E&P not yet subject to tax)	'Haircut' for Section 965(a); No Section 986(c) for Section 965(b)
	Annual last-in, first-out for remaining

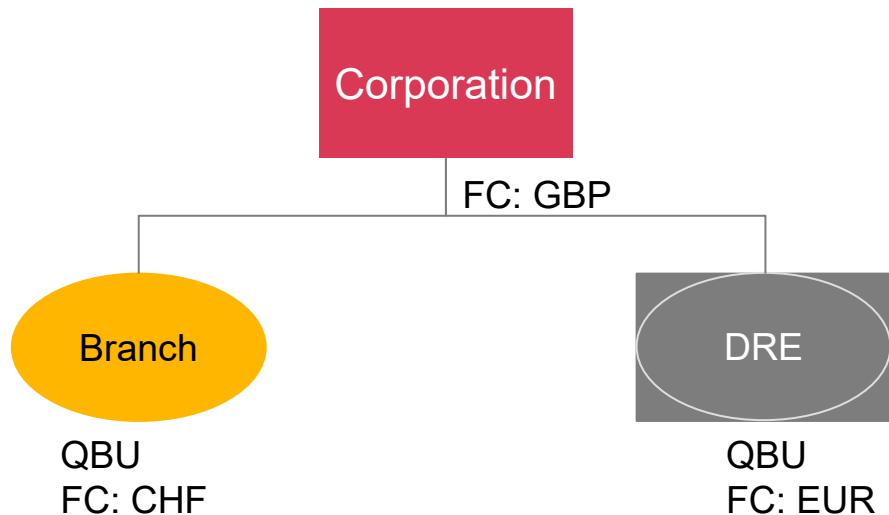


# Translational FX – Section 987

# Section 987 – Overview

<b>Who?</b>	<ul style="list-style-type: none"><li>• Generally, a US corporation or controlled foreign corporation (CFC) owns a branch, disregarded entity or partnership interest where the functional currency of that entity is different than that of the corporation</li></ul>
<b>What happens?</b>	<ul style="list-style-type: none"><li>• It requires the income of any Section 987 QBU to be properly translated into the functional currency of the owner</li><li>• It requires an amount of currency gain or loss to be recognized when a Section 987 QBU remits property or cash to its owner</li></ul>
<b>Character?</b>	<ul style="list-style-type: none"><li>• Ordinary income</li></ul>
<b>When?</b>	<ul style="list-style-type: none"><li>• A Section 987 QBU:<ul style="list-style-type: none"><li>◦ Makes a remittance of cash or property to the owner; OR</li><li>◦ Terminates</li></ul></li></ul>
<b>Source?</b>	<ul style="list-style-type: none"><li>• Based on the assets of the Section 987 QBU</li></ul>

# Section 987 – To whom does Section 987 apply?



## To whom does Section 987 apply?

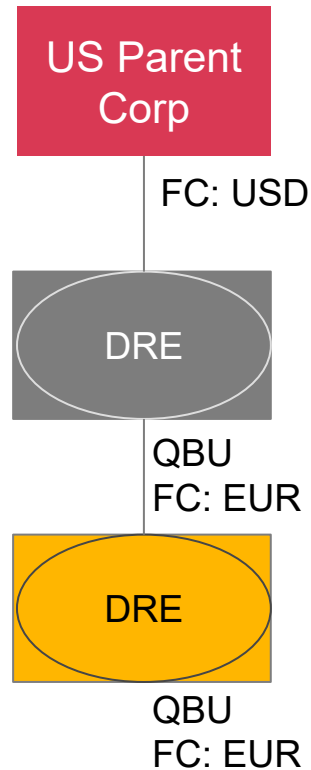
- Section 987 applies to most multinational corporations
- Section 987 applies to a US corporation or a CFC that owns a section 987 QBU. Special rules for partnerships.
- A section 987 QBU is any “**eligible QBU**” whose functional currency differs from that of its tax owner.
  - See Section 989(a) and Treas. Reg. sec. 1.989(a)-1(b) for the definition of “QBU.”
- Corporations are not Section 987 QBUs; FX gain / loss for corporate operations captured via Section 986(c)

# Section 987 – Section 987 QBU (continued)

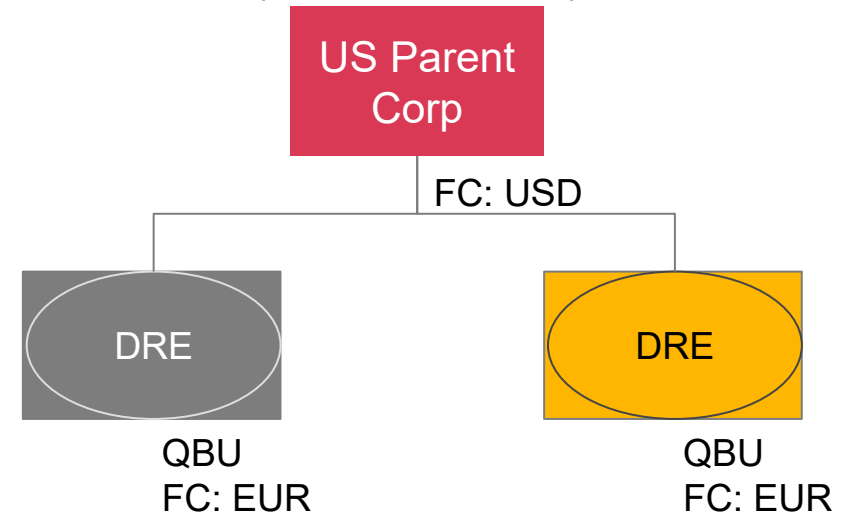
## Example

- **Tiered ownership structures** are treated as **flat** for purposes of Section 987 (see below)

Tiered structure  
(Legal ownership)

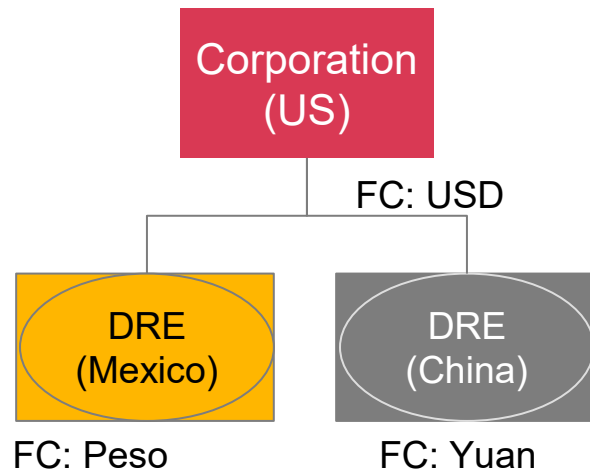


Flat structure  
(For Section 987)



# Section 987 – Example 1 - QBU owned by US corporation

## Example 1 - QBU owned by a US corporation



### Facts

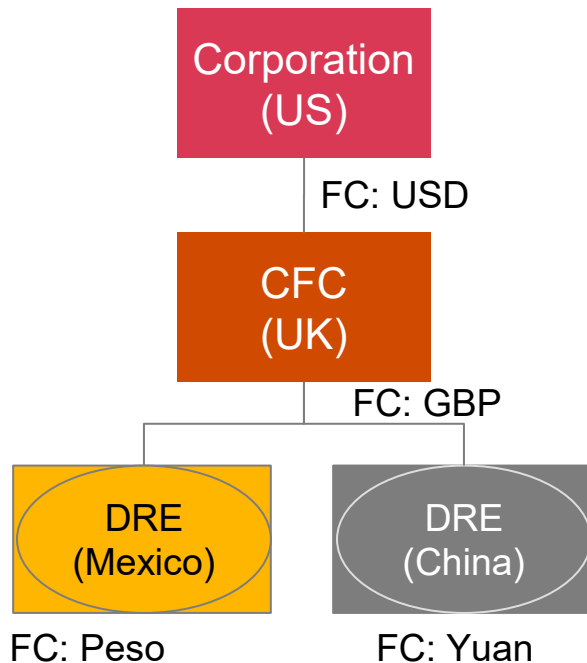
- US Corp owns disregarded entities in Mexico and China that have the peso and yuan, respectively, as their functional currencies
- The disregarded entities are operating companies that produce Product X

### Analysis

- The disregarded entities are Section 987 QBUs to US Corp

# Section 987 – Example 2 - QBU owned by a CFC

## Example 2 - QBU owned by a controlled foreign corporation (CFC)



### Facts

- US Corp owns a CFC
- CFC owns disregarded entities in Mexico and China that have the peso and yuan, respectively, as their functional currencies
- The disregarded entities are operating companies that produce Product X

### Analysis

- The disregarded entities are Section 987 QBUs to CFC
- CFC is not a Section 987 QBU of US Corp

# Section 987 – What does it do when it applies?

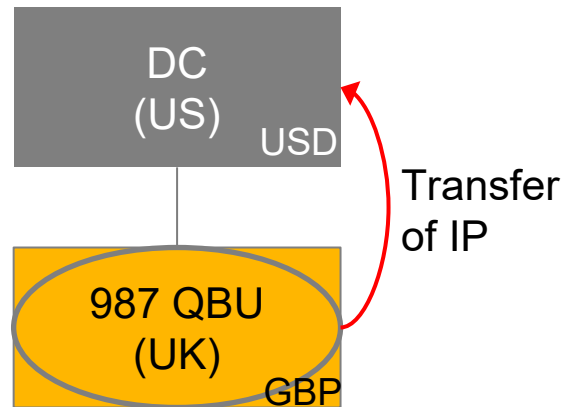
## What does Section 987 do when it applies?

- It requires the income of any Section 987 QBU to be properly translated into the functional currency of the owner
- It requires an amount of currency gain or loss to be recognized when a Section 987 QBU remits property or cash to its owners
- It requires an owner's basis in property remitted from a section 987 to be properly translated.

# Section 987 – Remittance

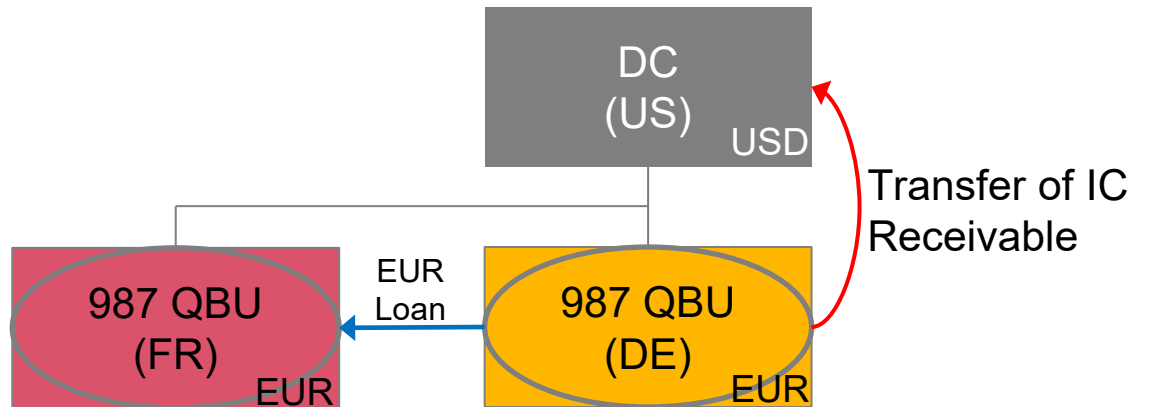
- The realization event for section 987 gain or loss is a “**remittance**” from the section 987 QBU.
- A remittance is generally the movement of cash or *regarded* assets off the tax books and records of a section 987 QBU.

## Example: Remittance



UK section 987 QBU distributes IP to its US owner. No other transfers in or out of the section 987 QBU during the year. The transfer is a remittance.

## Example: Not a Remittance



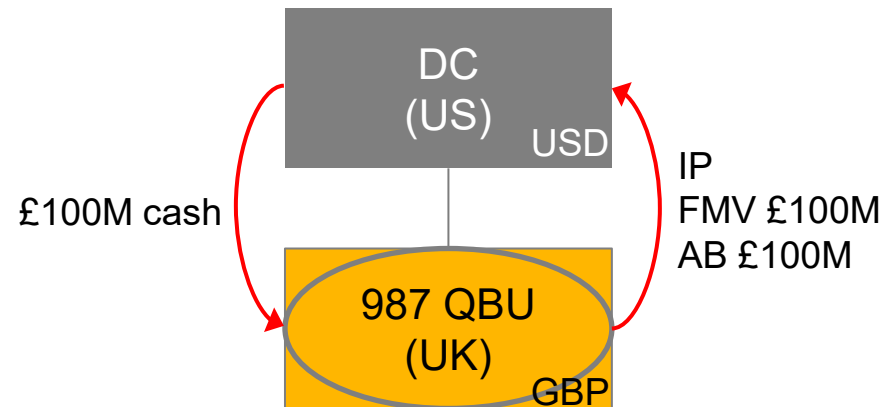
German section 987 QBU lends EUR to French section 987 QBU. Later, German section 987 QBU transfers the EUR receivable to its US owner. The transfer is not a remittance because the receivable is a disregarded asset for USFIT purposes and, therefore, is not carried on the tax books and records of the section 987 QBU.



# Section 987 – Remittance with Netting

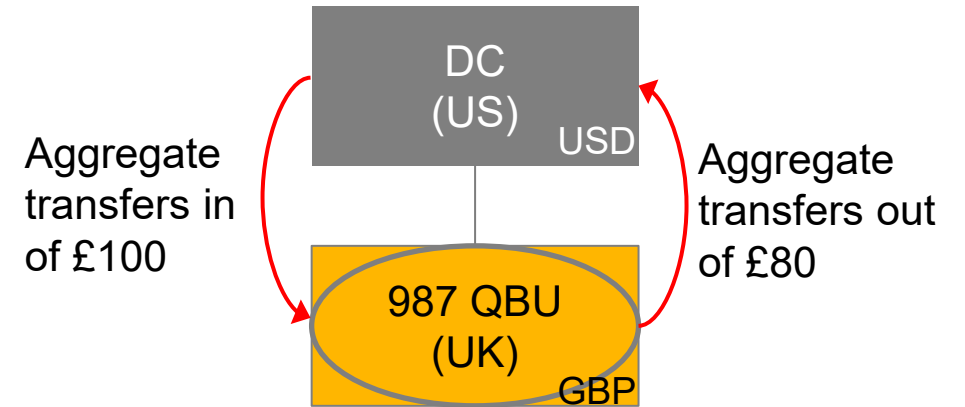
- Netting to determine whether a remittance has occurred—
  - Daily transfers in and out of a section 987 QBU are netted to determine distributions (daily net outflow) and contributions (daily net inflow).
  - Distributions and contributions are netted annually to determine whether there has been a net outflow from the section 987 QBU.
  - A remittance generally occurs when there is a net outflow over the annual netting period.

## Example: Not a Remittance



UK section 987 QBU sells IP to its US owner in exchange for GBP cash. The transfers occur on the same day, and the section 987 QBU's tax basis (determined in GBP) in the IP is equal to the GBP received. The section 987 QBU has neither a contribution nor a distribution on the day of the sale.

## Example: Not a Remittance



UK section 987 QBU has many transfers in and out over its tax year. The section 987 QBU uses an annual netting convention over which it has a net contribution of GBP 20. No remittance occurred during the tax year.

# Section 987 – Termination: General Rules

- When a section 987 QBU terminates, the section 987 QBU is treated as having made a remittance consisting of all its assets immediately before the section 987 QBU terminates.
  - Consequently, unless a special rule applies, a termination results in the recognition of any unrecognized section 987 gain or loss of the section 987 QBU.
- Under Treas. Reg. sec. 1.987-8(b), a section 987 QBU generally terminates when any of the following occurs
  - Based on all the facts and circumstances, the section 987 QBU ceases its trade or business.
  - The section 987 QBU transfers substantially all of its assets to its owner.
  - A CFC owner of a section 987 QBU ceases to be a CFC as a result of a transaction, and after such transaction, persons related to the CFC owner still own at least 50% of the CFC.
  - The owner of the section 987 QBU ceases to exist.
  - The section 987 QBU ceases to have a different functional currency than its owner
  - The owner of the section 987 QBU ceases to be the direct owner (i.e., becomes an indirect owner through a partnership)
- Exceptions apply for certain section 332 liquidations and 381(a) transactions (e.g., domestic-to-domestic transactions and certain foreign-to-foreign transactions).

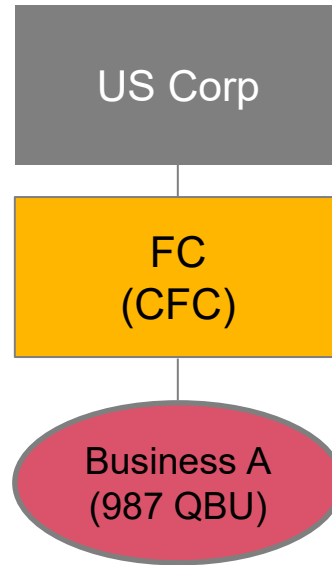
# Section 987 – Termination

Treas. Reg. sec. 1.987-8(f), Example 4

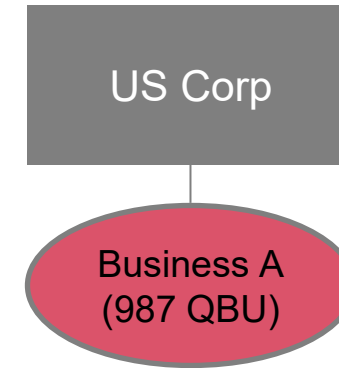
## Facts:

- U.S. Corp owns all of the stock of FC, a foreign corporation.
- FC is the owner of Business A.
- Pursuant to a liquidation described in section 332, FC transfers all its assets and liabilities to U.S. Corp.

## Starting Structure



## Ending Structure



## Analysis:

- FC's liquidation causes a termination of the Business A section 987 QBU because FC, the owner of the section 987 QBU, ceases to exist as a result of the liquidation. See Treas. Reg. sec. 1.987-8(b)(4).
- The exception for certain section 332 liquidations provided under Treas. Reg. sec. 1.987-8(c)(1) does not apply because U.S. Corp is a domestic corporation and FC is a foreign corporation. See Treas. Reg. sec. 1.987-8(c)(1)(ii).
- If FC were a US person, Business A section 987 QBU would not terminate under the exception for certain section 332 liquidations provided in Treas. Reg. sec. 1.987-8(c)(1).

# Section 987: 2024 Final Regulations

# Applicability dates

- Final regulations generally apply to tax years beginning after December 31, 2024, consistent with the 2023 proposed regulations.
- Retains the applicability date under which the final regulations apply to terminating Section 987 QBU if both:
  - 1) the Section 987 QBU terminates on or after November 9, 2023, or as a result of an entity classification election filed on or after November 9, 2023, and effective before November 9, 2023, and
  - 2) neither the new final regulations nor the 2016 and 2019 final regulations would apply to the Section 987 QBU when it terminates but for this accelerated applicability date.



# Comparing the guidance packages

1991 proposed regs	2016 final regs	2024 final regs
<b>Equity and basis pool method</b> <u>Equity pool</u> <ul style="list-style-type: none"> <li>Equals the total of the branch capital and earnings denominated in the functional currency of the QBU</li> </ul> <u>Basis pool</u> <ul style="list-style-type: none"> <li>Equals the total of the branch capital and earnings denominated in the functional currency of the owner of the QBU</li> <li>Branch capital is translated into the functional currency of the owner at the spot rate on the day of contribution</li> <li>Branch earnings are translated at the average rate for the year</li> </ul> <b>Earnings only method</b> <ul style="list-style-type: none"> <li>An offshoot of the 1991 proposed Section 987 regulations</li> </ul>	<b>Foreign exchange exposure pool</b> <ul style="list-style-type: none"> <li>Most income and expense items translated at the average rate for the current year</li> </ul> <u>Section 987 gain or loss</u> <ul style="list-style-type: none"> <li>Imputed with respect to 'marked items' on the balance sheet</li> <li>E.g., financial/liquid assets/liabilities</li> </ul> <u>No Section 987 gain or loss</u> <ul style="list-style-type: none"> <li>Items that are not 'marked items' are referred to as 'historic items'</li> <li>E.g., intangibles, plant, equipment, inventory and other property</li> <li>Historic items do not generate Section 987 gain or loss</li> </ul>	<ul style="list-style-type: none"> <li>Retain the FEEP method of the 2016 final regulations with modifications as the default rule for determining Section 987 taxable income or loss and net unrecognized Section 987 gain &amp; loss</li> <li>E.g., monetary assets are marked items and buildings are historic items (unless a current rate election is made in which case everything is marked – but subject to loss suspension)</li> <li>Current rate election (discussed more below) intended to be like 1991 Method (with differences)</li> </ul>

# What produces section 987 gain or loss under each method?

## Baseline Example:

US corporation ("USCo") owns Euro QBU. Euro QBU has the following:

Assets:

€ 150 Cash

€ 300 Depreciable Asset

Liabilities:

(€ 100) Acquisition Debt for Asset

Earnings: € 75

1991 proposed regs (Equity and basis pool method)	2016 final regs (Foreign exchange exposure pool)	2024 final regs (Various elections)
<b>Equity and basis pool method</b> <ul style="list-style-type: none"> <li>All assets and liabilities of the Euro QBU are included in the computation of the basis and equity pools</li> </ul> <b>Earnings only method</b> <ul style="list-style-type: none"> <li>€ 75 Earnings included in the earnings pool</li> <li>Assets and liabilities held at historic FX rate basis</li> </ul>	<b>Foreign exchange exposure pool</b> <ul style="list-style-type: none"> <li>€ 75 earnings translated at the average rate for the year (depreciation is restated using historic rates)</li> </ul> <u>Section 987 gain or loss</u> <ul style="list-style-type: none"> <li>€ 150 Cash and (€ 100) Acquisition Debt are "marked" items revalued annually</li> </ul> <u>No Section 987 gain or loss</u> <ul style="list-style-type: none"> <li>€ 300 Depreciable Asset held at historic FX rate basis (i.e., is a "historic" item)</li> </ul>	<ul style="list-style-type: none"> <li><b>Default:</b> FEEP method (see 2016 final regs column)</li> <li><b>Current rate election:</b> Equity and basis pool method (with adjustments)</li> <li><b>Annual recognition election:</b> MTM 987 annually</li> </ul>

# Overview of final regulations

## Methods for calculating Section 987 gain or loss:

- Default: Foreign Exchange Exposure Pool (FEEP) method (like the 2006 and 2016 regulations)
- Election: Current rate election (similar result to the 1991 regulations, subject to loss limitation rules)
- Election: Annual recognition election

## Transition:

- Generally, no Section 987 gain or loss triggered at the time of the transition
- Pretransition gain or loss by QBU needs to be calculated
- For QBUs without an eligible method, look back to taxable years beginning after September 7, 2006

## Timing for recognition of pretransition Section 987 gain or loss:

- Generally recognized when remittances are made post-transition
- Election: 10-year amortization of pretransition gain or loss



# Methods and elections

## Current rate election

- Treats all assets and liabilities that are properly reflected on the books and records of a Section 987 QBU as marked items (translated at the year-end spot rate) and to translate all items of income, gain, deduction, or loss with respect to a Sec. 987 QBU at the average exchange rate for the current tax year
- Expected to produce a result close to that reached by applying the method in the 1991 proposed regulations and more closely aligned with financial reporting, except that the 2024 final regulations exclude most stock, partnership interests (and the liabilities, if any, to acquire them) from the Section 987 pools

## Annual recognition election

- This election replaces the annual deemed termination election from the 2016 final regulations.
- It is an election under which a Section 987 QBU owner recognizes all net unrecognized Section 987 gain or loss at the end of each year.
- The Section 987 QBU also must translate all items of income, gain, deduction, or loss with respect to a Section 987 QBU at the average exchange rate for the current tax year but continue to translate marked items at the year-end spot rate and historic items at their historic rates.

- If the current rate election and annual recognition election are both in effect, all assets and liabilities that are properly reflected on the books and records of a Section 987 QBU are treated as marked items (translated at the year-end spot rate).
- These elections cannot be revoked without Commissioner consent for 5 years once made and cannot be made again for at least 5 years without Commissioner consent.

# Methods and elections (continued)

## Treatment of Section 988 transactions

- Whether a Section 987 QBU's asset or liability is a Section 988 transaction and the amount of Section 988 gain or loss is determined by reference to the QBU's functional currency instead of the owner's functional currency, including transactions denominated in the owner's functional currency.
- Treat Section 988 transactions of a Section 987 QBU as marked items.

## Section 988 mark-to-market election

- New election to permit taxpayers to elect to mark-to-market a Section 987 QBU's Section 988 transactions such that built-in Section 988 gain or loss on such transactions are realized annually.
- Generally does not apply to any built-in Section 988 loss existing prior to the Section 988 transaction's contribution to the Section 987 QBU unless the transaction was subject to mark-to-market in the hands of the transferor.
- Subject to the same timing and consistency requirements as the current rate and annual recognition elections (i.e., 60-month requirement and all Section 987 QBUs of the controlled group must make the election).

# Methods and elections (continued)

## QBU net value calculation

- Alternative computation for taxpayers making a current rate election by allowing a computation similar to the 'earnings and capital' method in the 1991 proposed regulations in lieu of a computation using tax basis balance sheets.
- Computes the QBU net value as of the last day of the tax year by adjusting the QBU net value at the end of the preceding tax year by:
  - transfers of assets and liabilities between the Section 987 QBU and its owner and
  - by income or loss of the Section 987 QBU (each determined in the Section 987 QBU's functional currency).

## Remittance and remittance proportion calculation

- Two modifications for computing Section 987 gain or loss.
  - An alternative formula for computing the annual remittance under which the remittance amount is equal to the negative change in net value of the Section 987 QBU (determined in the QBU's functional currency), adjusted for income or loss of the Section 987 QBU.
  - The numerator and denominator of the remittance proportion (i.e., the amount of the remittance and the Section 987 QBU's gross assets) are determined in the Section 987 QBU's functional currency, rather than the owner's functional currency.

# Suspended loss rules

## Loss to the extent of gain rule

- Suspends the recognition of the Section 987 loss of a Section 987 QBU that has made the current rate election.
- Suspended Section 987 loss can be recognized only to the extent that, for the tax year in question, the owner of the Section 987 QBU recognizes Section 987 gain that has the same character, source, section 904 treatment and/or subpart F characterization as the Section 987 loss realized. See next slide for the look-back rules.
- Applies at the owner level (rather than the QBU level), which means gain from one Section 987 QBU can offset loss from another (in the same recognition grouping).
- Suspended Section 987 loss that is not recognized is carried over to the owner's next tax year.

## Deferral events and outbound loss events

- Generally retain the principles of the 2019 final regulations for deferral events and outbound loss events with certain modifications.
- The de minimis threshold of \$5 million (which previously applied on a QBU-by-QBU basis) applies to the total deferred Section 987 gain or loss of the owner with respect to all of its Section 987 QBUs that would otherwise be deferred by the owner in a single tax year.

# Suspended loss rules

## De minimis exception for suspended Section 987 loss

- If a current rate election is in effect, Section 987 loss is not suspended unless the amount of Section 987 loss subject to suspension in the tax year exceeds the lesser of \$3M or 2% of the controlled group's gross income.
- Threshold is applied collectively to the Section 987 loss of the owner and all members of the owner's controlled group.

## Look-back rule for recognition of suspended Section 987 loss

- Suspended Section 987 loss is recognized to the extent of the tax owner's net Section 987 gain recognized in the current year and the three preceding post-transition tax years.
- For taxpayers that make both an annual recognition election and a current rate election, the look-back period includes all tax years in which both elections are continuously in effect.
- Section 987 gain recognized by the transferor corporation in the three years preceding the transaction is generally taken into account following a transaction described in Section 381(a), except for inbound reorganizations or liquidations.
- Anti-abuse rule.

# Other loss suspension rules

Section 987 losses arising from **certain outbound transfers** (e.g., a Section 351 contribution of a Section 987 QBU's assets) are suspended

Losses realized as a result of **transitioning onto the 2024 final regulations'** methodology are considered suspended Section 987 losses (unless the current rate election is made and the annual recognition election is not).

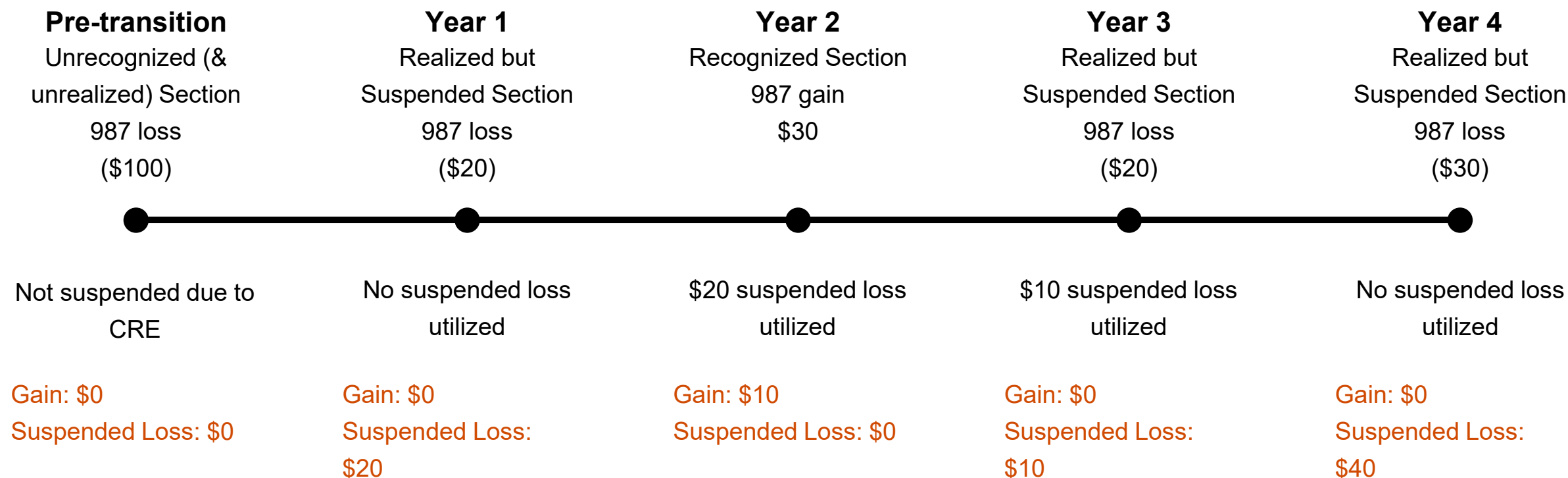
**Outbound Section 987 loss** is treated as suspended Section 987 loss, instead of being added to the basis of stock or recognized solely when the owner of the Section 987 QBU and the related foreign person cease to be related.

If a Section 987 loss is recognized in a **QBU termination** in which there is a successor QBU, the Section 987 loss is deferred and generally becomes attributable to the successor QBU.

If the owner of a Section 987 QBU or the original owner of a successor Section 987 QBU ceases to be a **member of the same controlled group as its successor Section 987 QBU, ceases to exist** including as a result of a Section 331 liquidation or inbound Section 332 liquidation or reorganization, all of the owner's suspended Section 987 loss is eliminated and will never be recognized.

## Assume the following:

- Taxpayer makes a CRE,
- Taxpayer does not make the amortization election, and
- All section 987 gain and loss has the same sourcing and character year to year.
- The pre-transition loss relates to the EUR QBU of Taxpayer.
- Remittances: years 1, 3, and 4 were remittances from the EUR QBU. Year 2 was a remittance from the GBP QBU of Taxpayer.



# Source and character of Section 987 gain or loss

- Under the 2024 final regulations, the character and source of Section 987 gain or loss is generally determined for all purposes of the Code (including for purposes of FTCs and subpart F) by assigning the Section 987 gain or loss to the statutory and residual groupings using the asset method of Reg. 1.861-9(g) and 1.861-9T(g) and using the tax book value method to determine the value of the Section 987 QBU's assets.
- The 2024 final regulations provide rules to coordinate this assignment of Section 987 gain or loss to a statutory and residual grouping with the rules for FTCs, GILTI, and subpart F.
- Section 987 gain or loss assigned to the same subpart F income group as the income generated by the Section 987 QBU's assets (e.g., foreign base company sales or services income or foreign personal holding company income (FPHCI)).
- Provides taxpayers with an election to treat Section 987 gain or loss that would otherwise be characterized as passive FPHCI as foreign currency gain or loss attributable to Section 988 transactions not directly related to the business needs of the CFC.



# Transition rules

- The 2024 final regulations provide a new transition rule that replaces the 2016 'fresh start' transition method.
  - Under this new transition method, for purposes of determining unrecognized Section 987 gain or loss in the first tax year in which the 2024 final regulations apply, the assets and liabilities on the Section 987 QBU's balance sheet at the end of the previous year are translated into the owner's functional currency at the spot rate on the day before the first day of the first tax year in which the regulations apply.
  - The owner of a Section 987 QBU must also determine the amount of Section 987 gain or loss that has accrued before the transition date and carry that gain or loss forward to be recognized at a future date in accordance with the gain and loss recognition rules of the 2024 final regulations.
- If the owner computed Section 987 gain or loss before the transition date using an eligible pretransition method (includes the 'earnings and capital' 1991 proposed regulations, 'earnings only' transition method or 2016 FEPP method), the owner can use that method to determine its pre-transition gain or loss (consistency rules apply). Note, adjustments may need to be made to take into account capital if an 'earnings only' method is used.

# Other rules

## Partnerships

- Did not finalize the 2024 final regulations on partnerships, and reserve on the application of detailed rules for applying Section 987 to partnerships.
- Reserve on the treatment of a partnership as a QBU under Section 989(a).
- Taxpayers must apply Sections 987 and 989(a) to partnerships and eligible QBUs of partnerships using a reasonable method consistent with the statute.
- Clarify that transactions between a taxpayer and its QBU generally are not Section 988 transactions, applies only to disregarded transactions.

## Net investment hedges of Section 987 QBUs

- Specific guidance where an owner of a Section 987 QBU enters into a hedging transaction that is a net investment hedge of the Section 987 QBU.
- Adjust their built-in Section 987 gain or loss by the amount of hedging gain or loss (rather than recognize the Section 988 gain or loss), subject to certain requirements.

# Overview of the proposed regulations

- Treasury and the IRS also released proposed regulations relating to the determination of taxable income or loss and foreign currency gain or loss with respect to a QBU.
- Includes an election that is intended to reduce the compliance burden of accounting for certain frequently recurring disregarded transactions between a QBU and its owner.
- Request comments relating to the treatment of partnerships and CFCs.
- The proposed regulations would apply to tax years beginning after the date the regulations are finalized.



# Recurring transfer group election

A taxpayer that has made a current rate election may elect to use the yearly average exchange rate to translate assets that are transferred between a Section 987 QBU and its owner as part of a recurring transfer group.

- Subject to the general timing and consistency requirements.



Recurring transfer group: a group of frequently recurring transfers between a Section 987 QBU and its owner (or another eligible QBU of the owner) that are made in the ordinary course of a trade or business.

- Only transfers made in connection with **sales of inventory, payments for services, or rent or royalty transactions** in which arm's length compensation has been paid would be included in a recurring transfer group.
- Does not include a transfer between the Section 987 QBU and its owner if the transfer (or a portion of the transfer) would be treated as a distribution with respect to stock, or an exchange for stock (or a contribution to capital), for US tax purposes if the QBU were treated as a separate corporation.

# Recurring transfer group election

- If a recurring transfer group election is in effect, assets transferred between a Section 987 QBU and its owner as part of a recurring transfer group are translated using the yearly average exchange rate in lieu of the applicable spot rate.
- Transfers made as part of a recurring transfer group would be disregarded for purposes of certain steps in computing unrecognized Section 987 gain or loss for the current tax year.
- The effect of a recurring transfer group election and related accounting for a disregarded transfer group in determining unrecognized Section 987 gain or loss for the tax year would not apply in a tax year if either:
  - more than 50% of the total amount transferred during the tax year is transferred during one quarter of the tax year or
  - more than 80% of the total amount transferred during the tax year is transferred during two quarters of the tax year.





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