

Request for Comments on the Revision of Proposed Section 987 Regulations

Notice 2000-20

Treasury and the IRS plan to review and possibly replace the proposed regulations issued under section 987 of the Internal Revenue Code of 1986. The current proposed regulations provide rules for determining the timing, source, character, and amount of foreign currency gain or loss recognized with respect to a qualified business unit (QBU) with a functional currency different from that of the taxpayer (*i.e.*, different from that of the taxpayer's home office) if the QBU does not use the dollar approximate separate transactions method of accounting. Treasury and the IRS are concerned that the proposed regulations may not have fully achieved their original goal of providing rules that are administrable and result in the recognition of foreign currency gains and losses under the appropriate circumstances. Accordingly, Treasury and the IRS request comments concerning issues that should be addressed in revised regulations under section 987.

Further, Treasury and the IRS are concerned about certain abusive transactions designed to create an inappropriate acceleration of foreign currency losses under section 987. These abusive transactions may involve a circular flow of funds between a foreign QBU and its U.S. parent. Treasury and the IRS intend to challenge these transactions under general tax principles and to issue regulations to prevent these abuses.

I. BACKGROUND

Treasury and the IRS published proposed regulations under section 987 on September 25, 1991. The proposed regulations provide rules for determining the timing, source, character, and amount of foreign currency gain or loss recognized with respect to a QBU branch (as defined in Prop. Treas. Reg. §1.987-1(a)(2)) that has a functional currency different from that of the taxpayer. The proposed regulations adopt the profit and loss method of computing foreign currency gain or loss

for purposes of section 987. Prop. Treas. Reg. § 1.987-1(b)(1).

Prop. Treas. Reg. §1.987-2(a)(1) provides that a taxpayer applying this profit or loss method recognizes gain or loss under section 987 upon a remittance (as defined in Prop. Treas. Reg. §1.987-2(b)(4)) from the QBU branch or upon the QBU branch's termination. Prop. Treas. Reg. §1.987-2(a)(2) provides an anti-abuse rule with respect to contributions to (or distributions from) a QBU branch that do not have a significant business purpose.

Prop. Treas. Reg. §1.987-2(b)(4) provides that the term "remittance" means the amount of any transfer (as defined below) from a QBU branch to the taxpayer to the extent that the aggregate amount of such transfers during the taxable year does not exceed the positive year-end balance of the equity pool as determined in Prop. Treas. Reg. §1.987-2(c)(1) (without regard to the decreases described in Prop. Treas. Reg. §1.987-2(c)(1)(iii)(B)). Prop. Treas. Reg. §1.987-2(b)(2) provides, in part, that the term "transfer" means the amount of property that, on any day, either is distributed from a QBU branch to the taxpayer (or to another QBU branch of the taxpayer) or is contributed by the taxpayer (or another QBU branch of the taxpayer) to the QBU branch. If contributions to the QBU branch from the taxpayer occur on the same day as distributions from the QBU branch to the taxpayer, these contributions and distributions are netted against one another, and only the net amount is treated as a transfer to (or from) the QBU branch. This rule is generally referred to as the "daily netting rule."

Section 987 gain or loss equals the difference between a remittance, translated into the taxpayer's functional currency using the spot rate at the date of the remittance, and the portion of the basis pool, determined under Prop. Treas. Reg. §1.987-2(c)(2), attributable to the remittance. Prop. Treas. Reg. § 1.987-2(d)(1).

II. REQUEST FOR COMMENTS ON THE PROPOSED SECTION 987 REGULATIONS

As noted above, Treasury and the IRS

are currently reviewing the proposed section 987 regulations to determine if such regulations are administrable and provide rules that call for the appropriate recognition of foreign currency gain or loss. Accordingly, Treasury and the IRS request comments on the application of section 987 generally and on the interaction of section 987 with other provisions of the Code, particularly with respect to the issues outlined below. With respect to any comments submitted under this notice, Treasury and the IRS request explanations of the extent to which the taxpayer's comments would differ depending on the type of QBU at issue, *e.g.*, a QBU that constitutes a branch, partnership, or trust.

A. Treatment of Contributions and Distributions of Capital to or from a QBU Branch Under Section 987

Treasury and the IRS are reevaluating the treatment under section 987 of contributions of capital to, and distributions of capital from, a QBU branch. Under the proposed section 987 regulations, the equity pool includes contributions of property to a QBU branch. Further, distributions of property from the QBU branch are treated as transfers that may constitute remittances and thus may trigger currency gain or loss, even if the property consists of tangible property previously contributed to the QBU branch (or acquired with funds previously contributed to the QBU branch), whose value is not affected by exchange rate fluctuations.

An approach different from the proposed regulations might compute currency gain and loss only on remittances of earnings, rather than taking remittances of capital into account. In most cases, this approach would align section 987 principles more closely with the principles of section 986(c). Treasury and the IRS request comments regarding the adoption of such an approach in the section 987 regulations, including comments on the use of a stacking or other rule to determine the extent to which remittances are attributable to earnings. Treasury and the IRS are also considering whether it might be appropriate to maintain a historic dollar basis in certain tangible assets for purposes of adjusting the equity and basis pools in lieu of calculating exchange gain or loss. Treasury and the IRS also request

comments regarding whether special rules should apply to assets the value of which is significantly affected by exchange rate fluctuations or to taxpayers who hold significant amounts of such assets in the ordinary course of their trade or business.

B. *Definitions of Transfer and Remittance*

1. *Use of an Annual Netting Convention*

Treasury and the IRS are considering providing detailed guidance on the definition of the term “transfer.” For example, Treasury and the IRS are considering an annual netting rule to determine the existence and amount of a transfer. Under this rule, a transfer to or from any QBU branch would consist of the net amount of property that, in any taxable year of the taxpayer, either is distributed from the QBU branch to the taxpayer (or to any other QBU branch of the same taxpayer) or is contributed by the taxpayer (or by any other QBU branch of the taxpayer) to the QBU branch. In comparison with the proposed regulations, this approach would be closer to the approach used in section 884 to determine the “dividend equivalent amount” of a U.S. branch of a foreign corporation. Treasury and the IRS expect that an annual netting rule would benefit taxpayers by decreasing the administrative burden associated with calculating the amount of a transfer. If an annual netting rule were adopted, the regulations might also provide that, for purposes of determining the existence or amount of any transfer, the IRS could disregard any distribution or contribution in appropriate circumstances to the extent that such conveyance is offset by either a distribution or a contribution (whether or not to or from the same QBU branch that was a party to the original distribution or contribution) made within 30 days (or other designated period) of the last day of the taxpayer’s taxable year.

As discussed in Part III, Treasury and the IRS are concerned that the daily netting rule in the definition of “transfer” in Prop. Treas. Reg. § 1.987-2(b)(2) is susceptible to manipulation by taxpayers and question whether it should be retained. Accordingly, Treasury and the IRS request comments regarding whether the daily netting rule yields a sufficiently accurate measurement of transfers during the taxable year, whether such a rule is

conceptually consistent with the regime applied to controlled foreign corporations under section 986, whether the rule is administratively burdensome for taxpayers, and whether the rule can be retained without giving rise to abuse.

2. *Transfers Between QBU Branches*

Under the proposed section 987 regulations, a property conveyance between two QBU branches of the taxpayer receives the same treatment as a property conveyance from a QBU branch to its home office. Comments are requested regarding whether it is appropriate to treat a property transfer between such QBU branches as a transfer from the distributing QBU branch to the home office, followed by a contribution of the same property from the home office to the recipient QBU branch. These comments should consider whether different results would be appropriate depending on the type of transaction, on whether the QBU branches share the same functional currency, or otherwise.

C. *Types of Property Whose Distribution Can Constitute a Transfer*

Under the proposed section 987 regulations, the term “transfer” includes the net amount of any property distributed by a QBU branch. Treasury and the IRS seek comments with respect to whether distributions of certain classes of property (e.g., inventory or other property normally transferred between the home office and the QBU branch in the ordinary course of business) should be distinguished from distributions of property more in the nature of a repatriation of earnings or capital and, if so, how such a distinction might be applied to prevent manipulation of section 987.

D. *Interaction Between Section 987 Regulations and the Partnership Rules*

Because a partnership is a QBU of each partner (under Treas. Reg. § 1.989(a)-1(b)(2)(i)), the notice of proposed rulemaking requested comments on the manner in which section 987 could be better coordinated with Subchapter K. Only one comment was received in response to this request. Due to the implementation of the “check-the-box” rules under Treas. Reg. § 301.7701-3, Treasury and the IRS expect increased taxpayer use of partnerships and disregarded entities, leading to increased interest in the interaction of the partnership and section 987

regimes. In addition to general comments on the interaction of section 987 and Subchapter K, Treasury and the IRS invite comments on the interaction of section 987 with the rules relating to actual and deemed partnership distributions and transfers of interests in partnerships. For example, as noted in the notice of proposed rulemaking, it is anticipated that section 987 will operate independently from the general rules in Subchapter K. Accordingly, although no gain or loss on a partnership distribution may be recognized under section 731, a partnership distribution (remittance) may give rise to currency gain or loss under section 987.

Additionally, the proposed regulations under section 987 provide for the recognition of currency gain or loss on the termination of a QBU branch. However, the proposed regulations reserve on the appropriate treatment of a termination of a QBU that is classified as a partnership. *See* Prop. Treas. Reg. § 1.987-3(e). Treasury and the IRS request comments addressing whether section 987 gain or loss should be triggered by reason of a partnership termination under section 708(b), including terminations under Treas. Reg. § 1.708-1(b)(1)(ii) (relating to termination due to the sale or exchange of a fifty percent or greater interest in the partnership). Moreover, Treasury and the IRS are examining whether currency gain or loss recognition under section 987 is appropriate where a partner terminates its interest in a partnership by reason of a sale or exchange of its partnership interest to a third party, rather than having its interest redeemed by the partnership.

Finally, comments are requested regarding the approach the section 987 regulations should take with respect to tiered partnerships and other tiered arrangements.

E. *Interaction with Financial Accounting Rules*

Financial accounting rules addressing the reporting of foreign currency gain or loss with respect to branches under FAS No. 52 differ materially from the statutory rules enacted by Congress in section 987. While these rules cannot be perfectly aligned, Treasury and the IRS request comments on whether, and the manner in which, the regulations should be more closely harmonized with financial accounting principles, either for policy rea-

sons or to reduce the administrative burden of complying with the regulations.

F. Section 351 Transactions and Related Issues

The proposed regulations treat the transfer of a QBU branch's assets in a section 351 transaction described in section 367(a) as a QBU branch termination. *See* Prop. Treas. Reg. § 1.987-3(c)(1). The regulations, however, reserve on providing guidance on other types of section 351 transactions. *See* Prop. Treas. Reg. § 1.987-3(c)(2). Treasury and the IRS request comments on examples of QBU branch asset transfers in section 351 transactions that should not be treated as QBU branch terminations. One such example might include the transfer of a QBU branch's assets between domestic members of a U.S. consolidated group. Treasury and the IRS request comments on the most appropriate method of determining section 987 gain and loss in the context of nonrecognition transactions involving other types of entities, such as partnerships and trusts.

G. Other Issues

Treasury and the IRS also request comments regarding other major issues that should be addressed as the section 987 proposed regulations are reexamined.

III. ABUSIVE ARRANGEMENTS

A. Applicability of Current Legal Principles

Treasury and the IRS have become aware that some taxpayers argue that the rule in the proposed section 987 regulations requiring daily netting of contributions and distributions allows them to recognize foreign currency losses prematurely with respect to purported transfers that do not constitute actual economic remittances (*i.e.*, from transactions that are undertaken for tax purposes and lack meaningful non-tax economic consequences). This opportunity is present when the spot rate is less than the historical rate used to determine the amount of capital and earnings in the basis pool. In such a situation, taxpayers have attempted to use circular cash flows consisting of a transfer of property from the QBU branch to the taxpayer on one day followed closely by a transfer of property from the taxpayer to the QBU branch on another day to recognize foreign currency losses without economically affecting the net

asset position of the QBU branch.

Treasury and the IRS believe that circular cash flows and similar transactions lacking economic substance will not result in recognition of foreign currency losses under general tax principles because such transactions are not properly treated as transfers or remittances under section 987. *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) (denying tax benefits from a transaction lacking economic substance); Rev. Rul. 99-14, 1999-13 I.R.B. 3 (denying tax deductions from a transaction lacking economic substance, citing, among other factors, the use of a circular flow of funds); *Erhard v. Commissioner*, 46 F.3d 1470 (9th Cir. 1995), *aff'g* T.C. Memo 1993-25, *cert. denied*, 516 U.S. 930 (1995) (denying tax benefits with respect to circular cash flow). *See also* Rev. Rul. 83-142, 1983-2 C.B. 68 (ignoring a circular flow of funds in determining the characterization of a transaction).

The following examples illustrate cases in which the IRS may challenge foreign currency losses under general tax principles. For purposes of these examples, assume P is a domestic corporation (with the dollar as its functional currency) that has QBU branch 1 in country X and QBU branch 2 in country Y. QBU branch 1 uses the u as its functional currency.

Example 1

On January 1 of year 5, P contributes 100u to QBU branch 1. On January 2 of year 5, QBU branch 1 distributes 50u to P. On January 4 of year 5, QBU branch 1 distributes another 50u to P. Assume the spot rate on these three days is less than the historical rate used to determine the amount of capital and earnings in the basis pool of QBU branch 1, so that a remittance would potentially result in recognition of a foreign currency loss. Further assume that the total of all transfers during the taxable year does not exceed the positive year end balance of the equity pool. Because the distributions by QBU branch 1 are offset by a contribution from P that occurred in close temporal proximity, the IRS will scrutinize this type of transaction and may disregard the contribution and distributions for purposes of section 987.

Example 2

On January 1 of year 5, QBU branch 1 distributes 100u to P. On January 4 of year 5, P contributes 100u to QBU branch 2. QBU branch 2 uses the account to which the 100u was deposited to pay the operating expenses and other costs of QBU branch 1. Assume the spot rate on January 1 of year 5 is less than the historical rate used to determine the amount of capital and earnings in the basis pool of QBU branch 1, so that a remittance would potentially result in recognition of a foreign currency loss.

Further assume that the total of all transfers from QBU branch 1 during the taxable year does not exceed the positive year end balance of the equity pool for QBU branch 1. Because QBU branch 1 continues to have use of the distributed property, the IRS will scrutinize this type of transaction and may disregard the 100u conveyance from QBU branch 1 to P for purposes of section 987.

B. Regulations to be Issued pursuant to this Notice

1. Clarification of Transfer and Remittance Definitions

Treasury and the IRS plan to issue regulations which will alter the definition of the terms "transfer" and "remittance" to clarify that transactions lacking economic substance will not be respected for purposes of recognizing currency losses on transfers between a QBU branch and its home office or between QBU branches of a single taxpayer (or related taxpayers). Circular cash flows, or any property distribution from a QBU branch followed or preceded (within a relatively short time period) by a contribution to that QBU branch or a distribution from a second QBU branch of the same taxpayer to that QBU branch, may not be treated as a transfer to the extent of the offsetting amount.

In addition, a contribution or distribution of property may be disregarded (*i.e.*, not treated as a transfer) if the unit making the contribution or distribution does not lose the use of the property for a significant period. For example, a distribution from a QBU branch to a bank account to which the QBU branch has access may be disregarded if the QBU branch retains the use or control of the property.

2. Change in Anti-Abuse Rule

Treasury and the IRS plan to modify the anti-abuse rule of Prop. Treas. Reg. §1.987-2(a)(2) to provide that if a contribution to or a distribution from (or a series of contributions to or distributions from) a QBU branch, or a termination of a QBU branch, lacks economic substance or is otherwise inconsistent with the purposes of section 987, then the Commissioner may make appropriate adjustments to properly reflect the economic effects of the transaction or any related or concurrent transaction.

Under the regulations to be issued under this notice, the above-described change to the anti-abuse rule will apply to contributions, distributions, and terminations occurring on or after March 21,

2000. Notwithstanding the above-described change to the anti-abuse rule, economic substance case law continues to apply to periods before (as well as after) the date this change takes effect.

VI. SUBMISSION OF COMMENTS

Written comments may be submitted to the Associate Chief Counsel (International), Attention: Rebecca Rosenberg (Notice

2000–20), Room 4562, CC:Intl:Br5, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC 20224. Alternatively, taxpayers may submit comments directly to the IRS Internet site at **http://www.irs.ustreas.gov/prod/tax_regs/comments.htm**

I. Comments will be available for public inspection and copying. Treasury and the IRS request comments by June 19, 2000.

For further information regarding this notice, contact Rebecca Rosenberg of the

Office of the Associate Chief Counsel (International) at 202-622-3870 (not a toll-free call).
