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February 24, 2010

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Proposed Regulations Under Section 987

Dear Commissioner Shulman:

Enclosed are comments concerning proposed regulations under Section 987. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William Wilkins, Chief Counsel, Internal Revenue Service  
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury  
Stephen E. Shay, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury  
Manal Corwin, International Tax Counsel, Department of the Treasury  
Michael Danilack, Deputy Commissioner, Large & Mid-Size Business Division (International), Internal Revenue Service

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**ABA SECTION OF TAXATION**  
**COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 987**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Paul Crispino and David Golden of the Committee on Foreign Activities of U.S. Taxpayers of the Section of Taxation. Substantive contributions were made by Michael Cornett, Kevin Cunningham, Jeanne Sullivan, Adam M. Cohen, Matthew Lay, and Dina A. Wiesen. The Comments were reviewed by Robert Peroni and Rebecca Rosenberg, Committee Vice-Chairs. The Comments were further reviewed by Reuven Avi-Yonah of the Section’s Committee on Government Submissions and Joan Arnold, Council Director for the Committee on Foreign Activities of U.S. Taxpayers.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 24, 2010

## EXECUTIVE SUMMARY

On September 7, 2006, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued Proposed Regulations (the “2006 Proposed Regulations”)<sup>1</sup> revising the previously issued Proposed Regulations under section 987<sup>2</sup> (the “1991 Proposed Regulations”).<sup>3</sup> The 2006 Proposed Regulations prescribe a new method for determining the income or loss of and the recognition of foreign currency gain or loss attributable to a qualified business unit (“QBU”) having a functional currency different from the taxpayer.

The 2006 Proposed Regulations provide that the computation of the taxable income or loss of a QBU is determined under the foreign exchange exposure pool method, described below, pursuant to which the basis of certain assets, and the deductions for depreciation, depletion or amortization of such assets, are translated at the historic exchange rate rather than the average exchange rate for the year. Gain or loss on the sale or exchange of “historic” assets, “marked” assets, and nonfunctional currency denominated assets are also subject to special translation rules involving the use of historic rates. Furthermore, the foreign exchange exposure pool method determines currency gain or loss based on a balance sheet approach, marking to market certain financial assets and liabilities (“marked items”) and aggregating changes in net worth attributable to movements in exchange rates on an annual basis. Currency gain or loss is not recognized until a remittance occurs or until the QBU terminates.

These Comments address areas in which we see significant open issues or in which we anticipate difficulty in applying the 2006 Proposed Regulations. Part I provides background information to put our comments in context and Part II contains our specific comments. Briefly, our principal recommendations are that:

- the expenses of financial institutions engaged in the leasing business be translated at the current exchange rate to match the treatment of the associated income;
- taxpayers be allowed to elect not to use the foreign exchange exposure pool method for a section 987 QBU that has a de minimis amount of net marked items and, thus, section 987 gain or loss;
- consolidated groups be permitted to elect to treat all group-owned section 987 QBUs having the same functional currency as a single QBU to simplify the section 987 calculations and permit the group to hedge foreign currency risk within the group without causing section 987 gain or loss;

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<sup>1</sup> 71 Fed. Reg. 52,876 (Sept. 7, 2006), corrected by 71 Fed. Reg. 77,654 (Dec. 27, 2006).

<sup>2</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>3</sup> 56 Fed. Reg. 48,457 (Sept. 25, 1991).

- taxpayers be permitted to directly allocate section 987 gain to particular assets of a section 987 QBU, and if such allocation is to a non-subpart F generating asset, none of the section 987 gain be characterized as subpart F income;
- entity-level treatment for partnerships be restored; and
- eligibility for the deferral transition method be expanded to permit a taxpayer that has reasonably complied with the section 987 rules to qualify for the method, even if some of its section 987 QBUs have incorrectly applied section 987.

## I. Introduction

### A. General Background

Before the enactment of section 987 in 1986, taxpayers generally used either a profit and loss or a net worth method to calculate the taxable income or loss attributable to a QBU operating in branch form.<sup>4</sup> Under the profit and loss method, the QBU branch's net profit, computed in its functional currency, was translated into dollars at the exchange rate in effect at the end of the taxable year, and remittances were translated at the exchange rate in effect on the date of the remittance. Under the net worth method, the QBU branch's taxable income was equal to the difference between the branch's net worth at the end of the current taxable year and its net worth at the end of the prior taxable year. In determining net worth, the branch's balance sheet was translated into dollars, with current assets translated at the year-end exchange rate and long-term assets and liabilities translated at the exchange rates in effect on the dates the assets were acquired or the liabilities were incurred (*i.e.*, using the historic exchange rates). Under the net worth method, remittances were translated at the exchange rate in effect on the date of each remittance and were taken into account in determining the overall change in net worth.

In the Tax Reform Act of 1986,<sup>5</sup> Congress enacted comprehensive rules for the tax treatment of foreign currency transactions, including rules governing the treatment of taxpayers having one or more QBUs with a functional currency other than the U.S. dollar. Congress concluded that the profit and loss method was more consistent with the adopted functional currency approach than a net worth method, which was viewed as inconsistent with general Federal income tax principles because of the recognition of exchange gain or loss before its realization.<sup>6</sup> Accordingly, Congress required taxpayers to use the profit and loss method to compute branch taxable income or loss.<sup>7</sup> Section 987 directs taxpayers to compute the taxable income or loss of each QBU in its functional currency and to translate such amount at the appropriate exchange rate.<sup>8</sup> The provision also directs the Secretary of the Treasury to provide rules for accounting for transfers of property between QBUs having different functional currencies.<sup>9</sup>

The 1991 Proposed Regulations required taxpayers having a QBU branch with a functional currency different from the taxpayer to compute the branch's taxable income or loss

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<sup>4</sup> These methods of calculating taxable income or loss were described in a series of 1975 revenue rulings that have since been declared obsolete. *See, e.g.*, Rev. Rul. 75-105, 1975-1 C.B. 29 (net worth method), *declared obsolete*, Rev. Rul. 2003-99, 2003-2 C.B. 388; Rev. Rul. 75-106, 1975-1 C.B. 31 (net worth method), *declared obsolete*, Rev. Rul. 2003-99, 2003-2 C.B. 388; Rev. Rul. 75-107, 1975-1 C.B. 32 (profit and loss method), *declared obsolete*, Rev. Rul. 2003-99, 2003-2 C.B. 388; Rev. Rul. 75-134, 1975-1 C.B. 33 (net worth method), *declared obsolete*, Rev. Rul. 2003-99, 2003-2 C.B. 388.

<sup>5</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>6</sup> S. Rep. No. 99-313, at 454, 470 (1986); *see also* Staff of Joint Comm. on Tax'n, 100th Cong., General Explanation of the Tax Reform Act of 1986, at 1090 (1987) ("1986 Bluebook").

<sup>7</sup> 1986 Bluebook, *supra* note 6, at 1109.

<sup>8</sup> I.R.C. § 987(1), (2).

<sup>9</sup> I.R.C. § 987(3). This paragraph also provides that any section 987 exchange gain or loss is ordinary in character and sourced by reference to the source of the income giving rise to the QBU's earnings.

using the profit and loss method of accounting.<sup>10</sup> These Regulations also provided rules for determining the timing, source, character, and amount of currency exchange gain or loss attributable to a QBU branch's earnings and capital. The 1991 Proposed Regulations determined the amount of currency gain or loss using a pooling approach that required taxpayers to compute both an equity pool, maintained in the QBU branch's functional currency and generally representing the amount of the branch's equity (*i.e.*, adjusted basis in assets less liabilities), and a basis pool, maintained in the taxpayer's functional currency and generally representing that taxpayer's tax basis in the equity pool.<sup>11</sup> A taxpayer recognized exchange gain or loss when its QBU branch made a remittance or terminated. A remittance occurred when a QBU branch having a positive equity pool balance made a transfer of property to the taxpayer or to a sister QBU, with the existence of a transfer determined on a daily basis by netting contributions and distributions to and from the QBU.<sup>12</sup> The 1991 Proposed Regulations generally provided that the exchange gain or loss recognized was equal to the difference between (i) the value of the remittance, determined by reference to the QBU branch's functional currency basis in the property distributed, translated into the taxpayer's functional currency at the spot rate on the date of the remittance, and (ii) the portion of the taxpayer's basis pool attributable to the property distributed, generally equal to the percentage of the equity pool distributed.<sup>13</sup>

In Notice 2000-20,<sup>14</sup> Treasury and the Service announced a plan to review and possibly replace the 1991 Proposed Regulations because of concerns that such Regulations may not have fully achieved their goal of providing rules that were both administrable and that resulted in the recognition of foreign currency gain and loss in appropriate circumstances. In particular, Treasury and the Service expressed concern about the potential manipulation of the daily netting rule, the recognition of currency gain or loss with respect to remittances consisting of distributions of property the value of which is not affected by exchange rate fluctuations, and abusive transactions, including transactions involving circular flows of funds between a QBU branch and its home office, designed to accelerate foreign currency losses.

On September 7, 2006, Treasury and the Service withdrew the 1991 Proposed Regulations and issued the 2006 Proposed Regulations to govern the determination of a QBU branch's taxable income or loss and the timing, source, character, and amount of currency gain or loss.<sup>15</sup> The 2006 Proposed Regulations adopt a new regime for determining currency gain or loss based on the so-called "foreign exchange exposure pool" or "FEEP" method. The preamble to the 2006 Proposed Regulations states that Treasury and the Service believe the FEEP method more accurately reflects foreign currency gain or loss than the 1991 Proposed Regulations because the FEEP method is designed to capture more precisely foreign currency gain or loss

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<sup>10</sup> Under the 1991 Proposed Regulations, the QBU branch's taxable income was computed in its functional currency, adjustments were made to conform the income to U.S. income tax principles, and the result was translated into the taxpayer's functional currency, generally at the average exchange rate for the taxable year. 1991 Prop. Reg. § 1.987-1(b)(1).

<sup>11</sup> 1991 Prop. Reg. § 1.987-2(c).

<sup>12</sup> 1991 Prop. Reg. § 1.987-2(a)(1).

<sup>13</sup> 1991 Prop. Reg. § 1.987-2(d).

<sup>14</sup> 2000-1 C.B. 851.

<sup>15</sup> 71 Fed. Reg. 52,876 (Sept. 7, 2006).

that is economically realized, while minimizing or eliminating the realization of non-economic currency gain or loss.<sup>16</sup>

## **B. Balancing Section 987 Benefits and Burdens**

The 2006 Proposed Regulations differ from the 1991 Proposed Regulations in several important respects. Although the computation of a QBU's taxable income or loss was described in the 1991 Proposed Regulations,<sup>17</sup> the FEED method adopted in the 2006 Proposed Regulations departs from the method described in the 1991 Proposed Regulations. Specifically, the FEED method requires the basis of certain assets, and the associated deductions for depreciation, depletion, and amortization of such assets, to be translated at the exchange rates in effect at the times such assets were acquired (the "historic rates") rather than at the average exchange rate for the year. Gain or loss on the sale or exchange of "historic" assets, "marked" assets, and nonfunctional currency denominated assets is also subject to special translation rules involving the use of historic rates. These changes have a material effect on the calculation of a QBU's taxable income or loss, relative to the calculation of such QBU's statutory income or loss, and accordingly require taxpayers to maintain separate books and records to track income or loss for purposes of section 987. Also, unlike the 1991 Proposed Regulations, the FEED method determines exchange gain or loss based on a balance sheet approach. Under this approach, exchange gain or loss with respect to assets or liabilities whose value fluctuates with respect to changes in the functional currency of the owner (so-called "marked items") is identified annually and aggregated in a pool with prior year changes.<sup>18</sup> Exchange gain or loss is not recognized until a remittance occurs or until the QBU terminates.<sup>19</sup>

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<sup>16</sup> In the preamble to the 2006 Proposed Regulations, Treasury and the Service state that Notice 2000-20 was issued, in part, as a result of the government's experience with taxpayers claiming large non-economic currency losses under section 987. 71 Fed. Reg. 52, 876, 52,879 (Sept. 7, 2006). The preamble notes that an important consequence of the equity pool paradigm is that all branch equity gives rise to exchange gain or loss, regardless of whether or not that equity is held in a form that actually exposes the QBU's owner to economic gains or losses due to currency fluctuations. *Id.* Thus, as the preamble illustrates, a taxpayer terminating a nonfunctional currency QBU that operates a mineral extraction business could recognize a currency loss under the 1991 Proposed Regulations (assuming that the QBU's functional currency declines relative to the owner's functional currency) even though the QBU's only assets consist of equipment that does not change its value in response to currency fluctuations. Of course, the converse may occur, as U.S. taxpayers are experiencing now as a result of the general weakening of the U.S. dollar against the euro and other currencies.

<sup>17</sup> Consistent with the profit and loss pooling method of the 1991 Proposed Regulations, the FEED method begins the calculation of the taxable income or loss of a QBU subject to section 987 (*i.e.*, a QBU having a functional currency different from its owner) by reference to the items of income, gain, deduction, and loss booked to the QBU in its functional currency, which items are then adjusted to reflect U.S. tax principles and translated into the owner's functional currency at the average exchange rate for the year. As mentioned in the text, however, a QBU's statutory accounts must be adjusted to take into account the treatment of historic items under the 2006 Proposed Regulations. Accordingly, a taxpayer may not simply rely on the items recorded in the QBU's local books to determine the QBU's U.S. taxable income or loss for the year.

<sup>18</sup> The preamble to the 2006 Proposed Regulations notes that Treasury and the Service believe that section 988(c) identifies the items that should be treated as giving rise to currency gain or loss for purposes of section 987. 71 Fed. Reg. 52, 876, 52,880 (Sept. 7, 2006). Accordingly, a marked item is generally defined as an asset or liability that would generate section 988 gain or loss if such asset or liability were held or entered into directly by the QBU's owner. 2006 Prop. Reg. § 1.987-1(d).

<sup>19</sup> 2006 Prop. Reg. § 1.987-5(a). The amount taken into account upon a remittance generally is equal to the product of the QBU's net unrecognized currency gain or loss multiplied by the ratio of the amount of the remittance to the

The 2006 Proposed Regulations also make several other important changes to the 1991 Proposed Regulations. Under the 2006 Proposed Regulations, only certain QBUs are subject to section 987, these being so-called “eligible QBUs.”<sup>20</sup> The definition is essentially the same as that of a QBU in the current section 989 Regulations, except that the definition in the 2006 Proposed Regulations incorporates an attribution requirement (*i.e.*, assets and liabilities must be reflected on the QBU’s books) and precludes the ability to use the dollar approximate separate transactions method or DASTM (as the 1991 Proposed Regulations also had done). Under the 2006 Proposed Regulations, a trade or business unit is an eligible QBU if it meets four requirements: (i) the unit must be engaged in an activity that is a trade or business as defined in Regulation section 1.989(a)-1(c); (ii) the unit must maintain separate books and records, as defined in Regulation section 1.989(a)-1(d); (iii) the assets and liabilities used to conduct the trade or business activity must be reflected in the unit’s books and records; and (iv) the unit’s activities cannot be subject to the dollar approximate separate transaction rules of Regulation section 1.985-3.<sup>21</sup> An eligible QBU is a “section 987 QBU” under the 2006 Proposed Regulations if the eligible QBU has a functional currency different from its owner.<sup>22</sup> In a significant change to the 1991 Proposed Regulations, the 2006 Proposed Regulations provide that neither a partnership nor a disregarded entity can be an eligible QBU.<sup>23</sup> In the context of a disregarded entity, which itself is not a recognized entity for tax purposes, this change likely has little practical significance because the disregarded entity’s activities may be viewed as an eligible QBU of the sole owner.<sup>24</sup> However, as discussed below, this change is significant in the context of a partnership.

## **II. Comments on 2006 Proposed Regulations**

### **A. Scope, Definitions and Special Rules**

#### **1. How should the FEED method apply to financial entities?**

##### **i. Definition of “financial entity”**

The 2006 Proposed Regulations do not apply to banks, insurance companies, and similar financial entities (including, solely for this purpose, leasing companies, financial coordination centers, regulated investment companies, and real estate investment trusts), resulting in such entities applying section 987 under existing law.<sup>25</sup> We understand the difficulty of applying

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aggregate basis of the section 987 QBU’s year-end gross assets, without reduction for the remittance. 2006 Prop. Reg. § 1.987-5(a), -5(b).

<sup>20</sup> Presumably, currency transactions of a trade or business activity that is not an eligible QBU, and therefore cannot be a section 987 QBU, are subject to section 988.

<sup>21</sup> 2006 Prop. Reg. § 1.987-1(b)(3)(i).

<sup>22</sup> 2006 Prop. Reg. § 1.987-1(b)(2)(i).

<sup>23</sup> 2006 Prop. Reg. § 1.987-1(b)(3)(ii).

<sup>24</sup> 2006 Prop. Reg. § 1.987-1(b)(4)(i); *see also* 2006 Prop. Reg. § 1.987-1(b)(7), Ex. 2(ii)(A).

<sup>25</sup> 2006 Prop. Reg. § 1.987-1(b)(1)(iii). The preamble to the 2006 Proposed Regulations provides that Treasury and the Service plan to apply the 2006 Proposed Regulations to financial entities in future guidance, and until then, such entities must comply with section 987 under a reasonable method, consistently applied. 71 Fed. Reg. 52, 876, 52,880 (Sept. 7, 2006).

section 987 to these types of entities, and we therefore provide recommendations below for addressing certain of these difficulties. As an initial matter, we suggest that the category of excepted entities be better defined. For example, currency dealers are included in the definition,<sup>26</sup> but whether commodities dealers are included is unclear. In addition, private investment vehicles, such as hedge funds and private equity funds, might constitute financial entities for this purpose, although it is not clear when that would be the case and to what extent.

Conversely, many of the reasons for providing special rules for banks and securities dealers (such as reconciling the section 987 concept of a remittance with a global dealing activity when the “book” moves from one section 987 QBU to another over the course of a 24-hour trading day) do not apply to finance coordination centers and internal banks. Moreover, it would be anomalous to apply the 2006 Proposed Regulations to all the operating companies transacting with a related coordination center, but not to the center itself. We therefore recommend that entities be excluded from the definition of financial entity (and thus become subject to the 2006 Proposed Regulations) if they primarily engage in transactions with related parties that are not themselves financial entities.

**ii. Application of 2006 Proposed Regulations to financial companies**

As the government recognizes, the 2006 Proposed Regulations must be tailored in several respects to address issues unique to financial companies.<sup>27</sup> Section 987 generally applies to financial companies only if they operate section 987 QBUs through hybrid entities, as they typically do not operate in branch form as banks do. Like other financial institutions, finance and leasing companies incur significant amounts of indebtedness in the ordinary course of business. In order to reduce risk, such companies generally seek to fund their operations with liabilities that closely match the characteristics of their assets, including the currency and duration. Due to these and other items that distinguish financial companies from their non-financial counterparts, we suggest that the 2006 Proposed Regulations be modified in several important respects before being applied to financial entities.

**a. Depreciation should be treated as a marked item in calculating taxable income under the FEET method**

Leasing is a form of financing in which the leased property, rather than money, serves as the principal amount. In many ways, a lease is similar to a loan. The value of both generally depends on the expected cash flow discounted for, among other things, credit and interest rate risks. Given this similarity, one would expect that the 2006 Proposed Regulations would treat a loan and a lease in a similar manner.

The 2006 Proposed Regulations, however, treat leased property and the associated depreciation expense as historic items, although the principal amount of a loan and interest

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<sup>26</sup> The preamble to the 2006 Proposed Regulations “requests comments on whether special rules are needed for the global dealing of currencies and securities.” 71 Fed. Reg. 52, 876, 52,880 (Sept. 7, 2006).

<sup>27</sup> Although these comments generally do not address the application of the 2006 Proposed Regulations to banks, many of the comments herein apply equally to banks.

amounts are marked items. This disparate treatment has at least three effects. First, because loan principal is a marked item and leased property is not, section 987 QBUs engaged in a lending business subject to the 2006 Proposed Regulations would generate greater section 987 gain or loss than similarly situated section 987 QBUs engaged in a leasing business, even when their income profiles are similar. Second, because section 987 QBUs engaged in a leasing business would not adjust depreciation expense to reflect current exchange rates, a leasing section 987 QBU effectively would experience an acceleration of its recognition of exchange rate fluctuations relative to a similarly situated finance section 987 QBU.<sup>28</sup> Such a result seems contrary to the purposes of section 987 to defer the recognition of exchange rate fluctuations until the occurrence of a remittance or termination event.<sup>29</sup> Third, if this acceleration of the current recognition of exchange rate fluctuations results in a section 987 loss, and the section 987 QBU that incurs the current loss is a separate unit within the meaning of the recently issued dual consolidated loss (“DCL”) Regulations, it is unclear whether this loss could be included in the computation of a DCL for which a domestic use is not permitted, even though that exchange loss is not a loss that can be put to foreign use since the income of the separate unit will be computed in the local currency.<sup>30</sup>

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<sup>28</sup> Treating current depreciation expense as an historic item generally accelerates currency gain when the owner’s functional currency weakens relative to the section 987 QBU’s functional currency and generally accelerates currency loss when the owner’s functional currency strengthens relative to the section 987 QBU’s functional currency. Take an example in which a section 987 QBU of a U.S. dollar owner having a functional currency of “u” leases property and earns 60u a year before depreciation expense. If the applicable depreciation expense were 40u, the section 987 QBU would earn 20u in its functional currency in Year 1. If the leased property were acquired in a period when the applicable exchange rate was \$1=1u and the applicable exchange rate remains the same during Year 1, the owner would recognize \$20 of taxable income from its section 987 QBU. At the end of the year, the change in the owner functional currency net value of the section 987 QBU would be \$20: end of year owner functional currency net value of \$20 (representing 60u of cash at \$1=1u and the leased property at its historic cost less \$40 of depreciation) less the owner functional currency net value at the beginning of the year, 0 (assuming that Year 1 was the first year of operation). The section 987 QBU’s foreign exchange exposure pool would be zero: \$20 of change in the owner functional currency net value of the section 987 QBU less \$20 of taxable income earned in Year 1. Assume the same facts in year 2, except that the U.S. dollar weakens relative to the u, so that the applicable exchange rate becomes \$1.2:1u. If the same results occurred in Year 2 as in Year 1, the section 987 QBU would report 20u of income for local purposes. The owner, however, would report \$32 of income under the 2006 Proposed Regulations (60u at \$1.2:1u, \$72, less \$40). At the end of the year, the change in the owner functional currency net value of the section 987 QBU would be \$44: end of Year 2 owner functional currency net value of \$64 (representing 120u of cash at \$1.2:1u and the leased property at its historic cost less \$80 of depreciation expense) less the end of Year 1 owner functional currency net value of \$20 (as computed above). At the end of Year 2, the section 987 QBU’s foreign exchange exposure pool would be \$12 (\$44 Year 2 net change in owner functional currency net value less the section 987 QBU’s Year 2 taxable income of \$32), which represents the change of currency effects on the section 987 QBU’s Year 1 cash of 60u (60u at \$1.2:1u, \$72, less \$60). If depreciation expense were treated as a marked item, however, the owner would recognize \$24 in year 2 (60u less 40u, 20u, at \$1.2:1u), rather than \$32. The \$8 difference between these results would appropriately reside, under the marked item approach, in the section 987 QBU’s foreign exchange exposure pool at the end of Year 2: the Year 2 change in the owner functional currency net value still would be \$44, but the section 987 QBU’s foreign exchange exposure pool would be \$20 (\$44 less QBU Year 2 taxable income of \$24), reflecting the additional \$8 of currency effects on the section 987 QBU’s depreciation expense.

<sup>29</sup> 71 Fed. Reg. 52,876 (Sept. 7, 2006) (stating in the preamble that “exchange gain or loss with respect to ‘marked items’ is identified annually but is pooled and deferred until a remittance is made”).

<sup>30</sup> Regulation section 1.1503(d)-5(c)(4)(v) states that section 987 gain or loss arising as the result of a transfer or remittance is not attributable to a separate unit or an interest in a transparent entity. If the currency loss arises from the computation of the separate unit’s own taxable income because of the computational rules in the 2006 Proposed Regulations, it is not clear whether the DCL section 987 gain or loss exclusion would apply because the section 987

We suggest that the owner's taxable income from a section 987 QBU should not be different for a lending or leasing section 987 QBU.<sup>31</sup> The differences under the 2006 Proposed Regulations stem from the FEEP method's use of the historic basis to determine items of income or loss to be taken into account in determining the section 987 QBU's taxable income or loss. We suggest that current items, especially depreciation, be translated at the current exchange rate for purposes of calculating a section 987 QBU's taxable income so that these current expenses, which contribute to the generation of income, are treated in the same manner as the associated income.<sup>32</sup>

**b. The definition of eligible QBU should be amended**

Financial companies, especially those operating in Europe, usually have assets, and matching liabilities, denominated in many different currencies. For example, a London-based finance company may have pound sterling, euro, zloty and U.S. dollar loans. If the finance company were a section 987 QBU having the pound as its functional currency, and its owner had the U.S. dollar as its functional currency, the 2006 Proposed Regulations would treat only the pound receivables and liabilities as section 987 marked items. The other loan receivables and matching liabilities would be treated as section 987 historic items, either because they are denominated in the owner's functional currency or because they are section 988 transactions with respect to the section 987 QBU.<sup>33</sup>

Given the prevalence of multi-currency loan and lease transactions within a single section 987 QBU, the 2006 Proposed Regulations would impose significant burdens on finance and lease companies operating through section 987 QBUs because section 988 would operate directly upon the companies' non-functional currency receivables and liabilities otherwise obtained in the ordinary course of business. This seems inconsistent with the purpose of section 987 to defer gains and losses from foreign currency movements until a remittance or

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gain or loss is not the result of a transfer or a remittance. Consequently, if different exchange rates are used for different income or loss items, then section 987 currency gain or loss effectively could be taken into account in the computation of the separate unit's DCL.

<sup>31</sup> The 2006 Proposed Regulations also would treat similarly situated leasing branches differently depending on whether the leasing branch owned the property leased. If it did, the depreciation expense associated with the branch's leasing income would be translated at the historic exchange rate. On the other hand, if it did not, the rental expense associated with the branch's leasing income would be translated at the current year's average exchange rate.

<sup>32</sup> We believe this approach, similar to that taken in Rev. Rul. 75-106, 1975-1 C.B. 31, is necessary to preclude inappropriate acceleration of unrecognized currency gain or loss (*i.e.*, exchange gain or loss that appropriately should be recognized only upon a remittance or termination event). Also, although we suggest treating depreciation as a marked item, we do not necessarily disagree with the conclusion in the 2006 Proposed Regulations that leased property should not be so treated. As noted above, the value of leased property generally reflects the value of its income stream. As this income is realized, the expenses contributing to the income should be netted against the income generated. But until that income arises, leased property is no different from other property the value of which may not fluctuate with changes in foreign currency. Accordingly, although we suggest that the taxable effects of depreciation be translated at a current rate, we acknowledge that the remaining U.S. dollar adjusted basis could be translated at an historic rate until such basis is recovered through depreciation deductions.

<sup>33</sup> 2006 Prop. Reg. § 1.987-3(e)(1) (treating section 988 transactions of a section 987 QBU as historic items); 2006 Prop. Reg. § 1.987-3(e)(2) (section 988 does not apply to transactions of a section 987 QBU denominated in, or determined by reference to, the owner's functional currency).

termination event.<sup>34</sup> We suggest that the final Regulations permit an owner to treat a multi-currency section 987 QBU as consisting of separate section 987 QBUs to the extent that the owner establishes that (i) a material portion (*e.g.*, more than five percent of the section 987 QBU's assets are denominated in a non-functional currency (as to the section 987 QBU and its owner)) and (ii) the non-functional currency assets and liabilities are clearly identified in the QBU's books and records.<sup>35</sup> In that case, Treasury and the Service might want to require that a taxpayer's affiliated group treat all (or all similarly situated) section 987 QBUs in the same manner.

## **2. The requirement to calculate annual exposure pool should be eliminated**

The 2006 Proposed Regulations impose an annual requirement to determine an owner's net unrecognized section 987 gain or loss with respect to a section 987 QBU.<sup>36</sup> Under the 1991 Proposed Regulations, while owners that operate section 987 QBUs were required to translate the QBUs' taxable income or loss into the owners' functional currency on an annual basis, they usually did not need to maintain basis and equity pools on an annual basis because section 987 gain or loss would be recognized only upon a remittance or termination event. Similarly, under the 2006 Proposed Regulations, no section 987 gain or loss arises unless there is a remittance or termination event. We suggest that Treasury and the Service consider deleting the requirement that owners maintain annual foreign exchange exposure pools. So long as owners maintain adequate supporting records to allow for a computation, we believe requiring an annual computation creates an unnecessary burden.

## **3. Termination Events**

### **i. Inbound asset transactions**

The 2006 Proposed Regulations treat an inbound asset transaction as a termination of a section 987 QBU. From a policy perspective, we agree with this approach. We recommend, however, that the exception in the 2006 Proposed Regulations be clarified for situations in which assets are transferred by one section 987 QBU to another located in the same jurisdiction when both QBUs have the same owner, even when two sets of books and records exist.<sup>37</sup>

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<sup>34</sup> As stated in the preamble to the 2006 Proposed Regulations, minimizing complexity regarding item-by-item translations should be one of the principles of regulations under section 987. *See* 71 Fed. Reg. 52, 876, 52,878 (Sept. 7, 2006).

<sup>35</sup> We recognize that if a controlled foreign corporation ("CFC") had multi-currency loans, a similar issue could arise. In these cases, it may be that the activities of the CFC in the non-functional currency rise to the level of an eligible QBU. Even if not, any volatility arising from multi-currency loans would not affect the U.S. shareholder directly unless the currency gain were determined to be subpart F income.

<sup>36</sup> 2006 Prop. Reg. § 1.987-4(a); *see also* 2006 Prop. Reg. § 1.987-9(b)(9), -9(b)(10) (an owner's obligation to maintain records is not met unless the records contain the amount of the unrecognized section 987 gain or loss for the taxable year and the amount of the net unrecognized section 987 gain or loss at the close of the taxable year).

<sup>37</sup> While 2006 Proposed Regulation section 1.987-8(b)(2), as illustrated in example 5 of 2006 Proposed Regulation section 1.987-8(e), would seem to cover the facts in the example, it is not entirely clear because there are two sets of books in the example described in the text, not one as in example 5 of the 2006 Proposed Regulations.

For example, assume a U.S. company owns a disregarded entity (“DE”) located in Country X. The activities of DE constitute a section 987 QBU. The owner terminates DE and receives its assets in liquidation of DE. The owner then continues the operations of DE in branch form and creates a new set of books and records for its branch. We believe that in this situation, when the owner still has a section 987 QBU in country X, the section 987 QBU should not terminate. Instead, we believe DE’s FEED balance should be transferred to the owner’s new branch.<sup>38</sup> Although the 2006 Proposed Regulations seem to adopt such an approach, it is not clear whether the exception in the Regulations is available when there is more than one set of books and records. We also believe a similar exception should apply if a section 987 QBU branch is converted into a DE, and in cases of tiered disregarded entities when the structure of the tier changes but the owner does not.

## **ii. Transactions within a consolidated group**

Under the 2006 Proposed Regulations, a transfer of a section 987 QBU, or its assets, among consolidated group members generally results in the termination of the QBU. The 2006 Proposed Regulations have requested comments on whether the rules of Regulation section 1.1502-13 should apply to this group of transactions. In addition to our recommendation that section 987 QBUs owned by consolidated group members be combined – see section II. B. below – we recommend that transactions among members of a consolidated group not result in a termination of a section 987 QBU, so long as the QBU continues operations. We believe that the existing consolidated return rules are adequate to address any issues that arise from a later transaction that triggers section 987 gain or loss with respect to the section 987 QBU.

## **4. Should taxpayers having minimal marked assets be permitted to elect out of the FEED method and simply apply section 988 directly?**

The complexity of the FEED method and the recordkeeping requirements would impose substantial burdens on taxpayers. At the same time, compared to the 1991 Proposed Regulations, the FEED method would generally reduce the amount of section 987 gain or loss recognized by most taxpayers. In particular, this would be the case when a taxpayer owns one or more section 987 QBUs with minimal marked items that may give rise to section 987 gain or loss. In these situations, the administrative burden on both the taxpayer and the government may outweigh any taxable income benefit from applying the FEED method to defer the recognition of foreign currency gain or loss. The 2006 Proposed Regulations recognize that in certain instances this weighing of burdens and benefits should result in an elective exception to the FEED method. For example, the preamble to the 2006 Proposed Regulations explains that the “IRS and the Treasury Department recognize that it may be administratively burdensome for taxpayers to apply certain aspects of the 2006 Proposed Regulations to section 987 QBUs indirectly owned through relatively small interests in partnerships.”<sup>39</sup> As a result, 2006 Proposed Regulation section 1.987-1(b)(1)(ii) provides that:

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<sup>38</sup> Similarly, if two section 987 QBUs having the same functional currency and owner, but which are not otherwise grouped, were merged or otherwise combined, no termination event should occur. Rather, their respective section 987 pools should be aggregated.

<sup>39</sup> 71 Fed. Reg. 52, 876, 52,881-82 (Sept. 7, 2006).

An individual or corporation that owns a section 987 QBU indirectly through a section 987 partnership may elect not to apply these regulations for purposes of taking into account the section 987 gain or loss of such section 987 QBU if the individual or corporation owns, directly or indirectly, less than five percent of either the total capital or the total profits interest in the section 987 partnership . . . .

We recommend that a similar election be permitted when a section 987 QBU has *de minimis* net marked items and, thus, will likely generate a *de minimis* amount of section 987 gain or loss. Instead of section 987 applying to these items, we recommend that an electing owner apply section 988 as if it held the marked items directly. As with the subpart F income *de minimis* rule of section 954(b)(3)(A), this election might be available when a section 987 QBU has net marked items (*i.e.*, marked assets less marked liabilities) no greater than the lesser of (i) an absolute amount (*e.g.*, \$10 million) or (ii) a percentage (*e.g.*, five percent of all the QBU's assets). As with the subpart F income *de minimis* rule, these amounts should be redetermined at the end of each taxable year.<sup>40</sup>

This type of election also raises a much broader issue: Should all taxpayers be permitted to apply section 988 in lieu of the FEEP method, even if they have more than *de minimis* marked items? We believe such an approach would have to be elective on the part of taxpayers, because section 987 is a statutory provision separate and distinct from section 988 that, among other things, only requires the realization of gain or loss on remittances from a section 987 QBU. Nevertheless, permitting a section 988 election may have some appeal for both the government and taxpayers.<sup>41</sup>

First, under a section 988 election, the taxpayer would be treated as holding directly QBU items enumerated in section 988(c)(1)(B).<sup>42</sup> This is consistent with the general aggregate approach toward QBUs taken by the 2006 Proposed Regulations, particularly when compared with the comprehensive entity approach of the 1991 Proposed Regulations.

Second, although a section 988 election may increase the number of individual transactions that a taxpayer must track separately, it reduces the number of separate tax regimes

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<sup>40</sup> If there was a concern that taxpayers might artificially divide what would otherwise be a single section 987 QBU into multiple section 987 QBUs to take advantage of a QBU-by-QBU *de minimis* rule, we believe a deemed grouping rule patterned after the elective grouping in 2006 Proposed Regulation section 1.987-1(b)(2)(ii) should apply. In addition, the rules of 2006 Proposed Regulation section 1.987-1(f) governing elections generally would be helpful.

<sup>41</sup> As discussed at various points in these comments, the 2006 Proposed Regulations already significantly restrict the scope of section 987.

<sup>42</sup> Section 988(c)(1)(B) lists the types of transactions that may qualify as "section 988 transactions" if the amount the taxpayer is entitled to receive or is required to pay is denominated in or determined by reference to a nonfunctional currency. Those transactions are –

- (i) The acquisition of a debt instrument or becoming the obligor under a debt instrument.
- (ii) Accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account.
- (iii) Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument.

and systems that it must follow.<sup>43</sup> This could substantially reduce the tax compliance burden on electing taxpayers without, over time, substantially decreasing their tax liabilities.<sup>44</sup>

Third, most items described in section 988(c)(1)(B) already fall out of the FEET method. The 2006 Proposed Regulations define a “section 987 marked item” subject to the FEET method as an asset or liability that (among other things) (i) would be a section 988 transaction if such item were held or entered into by the owner of the section 987 QBU, and (ii) is not a section 988 transaction with respect to the section 987 QBU (*i.e.*, an asset or liability in the section 987 QBU’s functional currency).<sup>45</sup>

Therefore, all other items described in section 988(c)(1)(B) (*i.e.*, assets or liabilities that (i) would not be section 988 transactions if held or entered into by the owner or (ii) are section 988 transactions with respect to the section 987 QBU) already are excluded from the FEET method and must be tracked separately. Accordingly, permitting an election to track all section 988(c)(1)(B) items, including those that would otherwise be section 987 marked items, could be attractive to many taxpayers.

Finally, allowing certain taxpayers (*e.g.*, banks and securities dealers) to elect to apply section 988 to all section 988(c)(1)(B) items of a section 987 QBU would help remedy some of the conceptual problems of coordinating the FEET method with other regimes. For example, a section 988 model would “fit” much better with global dealing rules than a FEET and remittance-based model.<sup>46</sup>

## **B. The Grouping Rules Should be Extended to Members of Consolidated Groups**

The preamble to the 2006 Proposed Regulations requests comments on whether a grouping election should be available to treat section 987 QBUs of consolidated group members as a single section 987 QBU, and if so, how this should be technically effectuated. The 2006 Proposed Regulations already allow an owner to elect to treat certain section 987 QBUs having the same functional currency as a single section 987 QBU.<sup>47</sup> As explained in the preamble, this election simplifies section 987 calculations by reducing the number of interbranch transactions that are transfers of assets and liabilities between section 987 QBUs.<sup>48</sup>

We suggest that you consider permitting a common parent of a consolidated group to elect to treat all section 987 QBUs with the same functional currency owned within a single consolidated group as a single section 987 QBU. As noted above, the 2006 Proposed

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<sup>43</sup> A section 988 election for marked items is not unlike the transaction-by-transaction approach to the computation of exchange gain or loss generally used before the development of the separate branch accounting principles described in the 1975 revenue rulings discussed in note 4 *supra*. See also 1986 Bluebook, *supra* note 6, at 1091.

<sup>44</sup> This is because over time an electing taxpayer’s section 988 gain or loss should generally equal a non-electing taxpayer’s combined section 988 and section 987 gain or loss.

<sup>45</sup> 2006 Prop. Reg. § 1.987-1(d)(2)-(3). These assets and liabilities are defined as “section 987 marked items.”

<sup>46</sup> Another possible alternative would be to provide taxpayers with an election to treat all such items as marked items under the FEET model.

<sup>47</sup> 2006 Prop. Reg. § 1.987-1(b)(2)(ii).

<sup>48</sup> 71 Fed. Reg. 52, 876, 52,881 (Sept. 7, 2006).

Regulations already provide grouping rules, for section 987 QBUs owned by a single member, which reduce the number of interbranch transactions that would be considered transfers of assets and liabilities and which simplify the overall section 987 calculation. We recommend extending the grouping rules to section 987 QBUs of different members of a consolidated group because this extension would both further simplify the section 987 calculation and permit the group to hedge foreign currency risk within the consolidated group without causing section 987 gain or loss.

We acknowledge some incremental complexities in connection with the interaction between a section 987 grouping election and the consolidated return rules. A section 987 grouping election would not completely eliminate interbranch transactions because separate entity accounting often is required with respect to transactions between separate members.<sup>49</sup> Moreover, two section 987 QBUs owned by different members in a consolidated group that are grouped in a single section 987 QBU would nevertheless have to make separate determinations of section 987 taxable income or loss (and an accompanying basis adjustment). The section 987 taxable income or loss also would reflect a transaction between grouped section 987 QBUs if income or loss on the transaction is otherwise required to be recognized by the consolidated return Regulations. For example, if one member of a group makes a loan to another member, each member would be required to recognize the interest income and expense, even if the members were grouped pursuant to a section 987 grouping election. Notwithstanding the incremental complexity, we believe the benefit of combining section 987 QBUs outweighs the additional complexity. As discussed above, a section 987 grouping election would be beneficial because it would permit intergroup hedging among different members of the same group and would simplify the section 987 calculations.

We also note that Treasury and the Service extended the separate unit combination rule to separate units of consolidated group members in the final DCL Regulations.<sup>50</sup> The rule was extended because the items of such combined separate units generally are taken into account in both the United States and the foreign country, and therefore grouping was found to be consistent with the underlying policies of the DCL rules.<sup>51</sup> Similarly, as discussed above, we believe that extending the section 987 grouping rules to section 987 QBUs of consolidated group members would be consistent with the underlying policies of section 987.<sup>52</sup>

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<sup>49</sup> The 2006 Proposed Regulations provide an example of an intercompany sale of equipment between two section 987 QBUs that are disregarded entities for U.S. federal income tax purposes and that are both owned by a single taxpayer. The two disregarded entities are presumably not subject to a grouping election under 2006 Proposed Regulation section 1.987-1(b)(2) for U.S. federal income tax purposes, although the example does not explicitly state that this is the case. *See* 2006 Prop. Reg. § 1.987-2(c)(9), Ex. 3. The example indicates that the intercompany sale would be disregarded, but the transfer is viewed as a remittance to the owner for section 987 purposes. That result is the opposite of the result that would occur when equipment is sold between two section 987 QBUs that are grouped within a consolidated group, but owned by different members (*i.e.*, in that case, the sale would be respected for Regulation section 1.1502-13 purposes, but there would be no remittance to the owner for section 987 purposes). We recommend that the example in the 2006 Proposed Regulations be modified to clarify that the two section 987 QBUs are not subject to a grouping election.

<sup>50</sup> Reg. § 1.1503(d)-1(b)(4)(ii).

<sup>51</sup> T.D. 9315, 72 Fed. Reg. 12,902, 12,903 (Mar. 19, 2007).

<sup>52</sup> Unlike the DCL combination rules, the 2006 Proposed Regulations permit grouping on an elective basis. 2006 Prop. Reg. § 1.987-1(b)(2)(ii).

### **C. Interaction with Other Foreign Currency Provisions - Consistent Attribution Rules Should be Provided**

The 2006 Proposed Regulations provide rules for attributing assets and liabilities, and items of income, gain, deduction, and loss, to an eligible QBU. Under 2006 Proposed Regulation section 1.987-2(b), items are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records of the eligible QBU. Under the 2006 Proposed Regulations, the following items are not considered to be on the books and records of an eligible QBU:

- (i) Non-portfolio stock of a corporation,
- (ii) An interest in a partnership,
- (iii) A liability incurred to acquire the stock or the interest in a partnership, and
- (iv) Income, gain, deduction, or loss arising from any of these items.<sup>53</sup>

The 2006 Proposed Regulations also provide that these attribution rules apply solely for purposes of section 987.<sup>54</sup> It may, however, not be helpful to limit the attribution rules in this manner.

Books and records, and the items recorded thereon, are important for other purposes in subpart J. For example, Regulation section 1.989-1(a) defines a QBU as “any separate or clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained.” Regulation section 1.985-1(c)(1) provides that a QBU’s functional currency is generally the currency of the QBU’s economic environment “if the QBU keeps . . . books and records in such currency.” Thus, an entity might qualify as a QBU and have a functional currency different from that of its owner based on books and records maintained under principles different from the attribution rules of 2006 Proposed Regulation section 1.987-2(b).<sup>55</sup> We therefore recommend that Treasury and the Service amend the Regulations under both sections 989 and 985 to cross-reference the attribution rules of the 2006 Proposed Regulations to prevent any such anomalies.

Revising the section 989 Regulations also would cure an ambiguity raised in example 1 of 2006 Proposed Regulation section 1.987-1(b)(7). In this example, X, a domestic corporation, owns DE1, which keeps a separate set of books and records in British pounds. DE1 owns British pounds and 100% of the stock of a foreign corporation (“FC”). DE1 is liable for a pound-denominated borrowing incurred to acquire the stock of FC. DE1 has no other assets or liabilities and conducts no activities other than holding the cash and the FC stock and servicing the liability.

Because the FC stock and the liability incurred to acquire the stock would not be considered to be on the books and records of DE1 under 2006 Proposed Regulation

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<sup>53</sup> 2006 Prop. Reg. § 1.987-2(b)(2).

<sup>54</sup> 2006 Prop. Reg. § 1.987-2(b)(1).

<sup>55</sup> We note that such a QBU might not qualify as an “eligible QBU,” because that term requires not only that the activities constitute a trade or business as defined in Regulation section 1.989(a)-1(c), but that the separate set of books and records maintained with respect to the activities reflects only the assets and liabilities of such activity as permitted under 2006 Proposed Regulation section 1.987-2(b).

section 1.987-2(b), the example concludes that DE1 is not an eligible QBU. This is clearly the result for section 987 purposes due to the special exclusions in the attribution rules. The example also concludes, however, that “[h]olding stock of FC and pounds, and servicing a single liability, does not constitute a trade or business within the meaning of Regulation section 1.989(a)-1(i).” This conclusion is not as clear under the section 989 Regulations. The question of whether a holding company rises to the level of a QBU under section 989 has been the subject of some discussion and uncertainty.<sup>56</sup> We therefore recommend reconciling the section 989 and section 985 Regulations with the attribution rules of the 2006 Proposed Regulations to avoid these and other potential anomalies.

## **D. Character and Source**

### **1. Character on sale of asset**

The 2006 Proposed Regulations provide rules for determining the exchange rates to be used in translating items of income, gain, deduction, or loss of a section 987 QBU into the owner’s functional currency.<sup>57</sup> In the case of gain or loss from the sale of property, the amount realized on the sale is generally translated at the yearly average exchange rate.<sup>58</sup> Adjusted basis, however, is generally translated at the historic rate.<sup>59</sup>

Other rules provide for the treatment of section 988 transactions. Specifically, the 2006 Proposed Regulations state “[e]xcept as provided in paragraph (e)(2) of this section, section 988 shall apply to the section 988 transactions attributable to a section 987 QBU under § 1.987-2(b)” and further provide that “[s]uch transactions are section 987 historic items as defined § 1.987-1(e).”<sup>60</sup>

It is not clear how these two rules interact when the sale is a section 988 transaction. The 2006 Proposed Regulations provide an example of the application of the section 988 rules. In this example, a U.S. corporation owns French DE, a disregarded entity that has a section 987 QBU branch with the euro as its functional currency. If French DE performs services for a U.K. person and receives £10,000 in compensation on January 12, 2009 (when the exchange rate was £1 = €1.25), and subsequently disposes of the £10,000 for €10,000 on October 16, 2009, the example tells us that the disposition is a section 988 transaction under section 988(c)(1)(C).<sup>61</sup> Accordingly, the example states, French DE will realize a loss of €2,500 (€10,000 amount realized less €12,500 basis). Under 2006 Proposed Regulation section 1.987-3(b)(1), the U.S. corporation translates the €2,500 loss into dollars at the yearly average euro to dollar exchange

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<sup>56</sup> See Doernberg & Coursant-Morris, *QB or Not QB U: Holding Companies and Qualified Business Units*, 2003 TAX NOTES TODAY 140-31 (July 18, 2003).

<sup>57</sup> 2006 Prop. Reg. § 1.987-3(b).

<sup>58</sup> 2006 Prop. Reg. § 1.987-3(b)(2)(ii)(A)(1). In contrast, the amount realized on the sale of marked assets other than cash is translated at a spot rate. 2006 Prop. Reg. § 1.987-3(b)(2)(ii)(A)(2).

<sup>59</sup> 2006 Prop. Reg. § 1.987-3(b)(2)(ii)(B)(1). As with the rate used for translating the amount realized, the rate used for translating the basis of a marked asset other than cash is a spot rate. 2006 Prop. Reg. § 1.987-3(b)(2)(ii)(B)(2).

<sup>60</sup> 2006 Prop. Reg. § 1.987-3(e)(1). Certain transactions denominated in or determined by reference to the owner’s functional currency are not section 988 transactions. 2006 Prop. Reg. § 1.987-3(e)(2).

<sup>61</sup> 2006 Prop. Reg. § 1.987-3(f), Ex. 10(ii).

rate. Given that the average exchange rate is €1 = \$1.05, the U.S. corporation translates the €2,500 section 988 loss to \$2,625.

The approach in the example of first applying section 988 to determine the amount of any gain or loss at the QBU level and only then applying the translation rule of section 987 appears to us to produce the correct result. We, therefore, suggest that the interplay of these two rules be clarified in the text of the final Regulations.

## **2. Source of subpart F income**

Like the 1991 Proposed Regulations, the 2006 Proposed Regulations source and characterize section 987 gain or loss in the same manner as interest expense. Unlike the 1991 Proposed Regulations, however, the 2006 Proposed Regulations require the owner to use only the asset method of Temporary Regulation section 1.861-9T(g) to characterize and source section 987 gain or loss. The modified gross income method may not be used. An example in the 2006 Proposed Regulations illustrates the application of the sourcing rule. In the example, a portion of the section 987 gain is characterized as subpart F income, based on the income categories of the CFC's assets.<sup>62</sup> We recommend that an exception to the general allocation rule be provided if an owner establishes that section 987 gain or loss directly relates to particular assets of a CFC. For example, we recommend that if an owner establishes that section 987 gain relates to a non-subpart F income generating asset, then none of the section 987 gain should be characterized as subpart F income.

### **E. Coordination with Subchapter K**

We believe that the methodology in the 2006 Proposed Regulations is complex and that the methodology would impose a substantial burden on taxpayers. We also believe that the application of the FEEP method to partnerships would be even more complex and that the amount of information that partners and partnerships would need to exchange to comply with the approach of the 2006 Proposed Regulations would be significant.

Given the complexity of applying the FEEP method to partnerships, which is difficult to resolve, we request that Treasury and the Service reevaluate the approach of the 2006 Proposed Regulations to partnerships. If the final Regulations include provisions applicable to partnerships, we suggest that the Regulations restore entity-level treatment for partnerships. Even if the final Regulations apply entity-level treatment to partnerships, however, we believe that significant additional guidance will be required. We request that this additional guidance be issued in proposed form so that taxpayers may provide comments before the guidance is effective. Our comments with respect to specific issues follow.

#### **1. Aggregate or entity treatment**

The 2006 Proposed Regulations adopt an aggregate approach in applying section 987 to disregarded entities and partnerships. Although the activities of a partnership may constitute one or more section 987 QBUs ("PRS QBUs"), the partnership itself is neither an eligible 987 QBU

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<sup>62</sup> 2006 Prop. Reg. § 1.987-6(c).

nor the owner of an eligible QBU.<sup>63</sup> The FEED method requires that each partner's share of a PRS QBU be reflected on the partner's balance sheet for purposes of determining the partner's pool of unrecognized foreign currency gain or loss.<sup>64</sup> In this section of these Comments, we refer to a partner's share of a PRS QBU as the partner's QBU.<sup>65</sup>

Under the 2006 Proposed Regulations, while certain activities, assets, and liabilities of a partnership may be treated as comprising one or more section 987 QBUs, the partnership itself (and possibly some subset of its activities, assets, and liabilities) is not treated as a section 987 QBU. This is a significant change from current practice: both the 1991 Proposed Regulations and Regulation section 1.989(a)-1(b)(2)(i) treat a partnership as a QBU of its partners. For a number of reasons, we recommend that Regulations, when finalized, restore entity-level treatment for partnerships.

1. The aggregate approach of the 2006 Proposed Regulations does not give sufficient recognition to a partnership as a joint undertaking of business activities that is authorized and regulated by subchapter K. The examples below illustrate certain of the issues raised under the 2006 Proposed Regulations by common partnership transactions and arrangements.

It is unclear how the FEED method is coordinated with the partnership rules. For example, when a partner contributes property to a partnership under section 721, the contributed property (with exceptions such as those provided in section 704(c)) becomes partnership property that is shared among the partners. This sharing is evident in Regulation section 1.704-3, which prescribes certain acceptable methods for sharing depreciation deductions when a partner contributes to a partnership depreciable property with a fair market value in excess of its adjusted tax basis. These methods share depreciation deductions so that the non-contributing partners receive tax results that are consistent with their economic arrangement.

One approved depreciation method that presents particular difficulties under the approach of the 2006 Proposed Regulations permits curative allocations of depreciation deductions to non-contributing partners to compensate them for inadequate tax deductions generated by the contributed property.<sup>66</sup> A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book items.<sup>67</sup> A curative allocation might involve the allocation of tax depreciation from another partnership asset to the shortchanged partner. If the property being depreciated and the property with respect to which a curative allocation could ordinarily be made are not part of the same section 987

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<sup>63</sup> 2006 Prop. Reg. § 1.987-1(b)(3), -1(b)(4) (partnership cannot be an eligible QBU); 2006 Prop. Reg. § 1.989(a)-1(b)(2) (partnership is not a per se QBU).

<sup>64</sup> See 2006 Proposed Regulation section 1.987-4 for the description of the seven steps required to determine the section 987 QBU's functional currency net value and the computation of the owner's pool of net accumulated unrecognized section 987 gain or loss and 2006 Proposed Regulation section 1.987-7 for the application of section 987 to partnerships.

<sup>65</sup> This is consistent with the examples under 2006 Proposed Regulation section 1.987-7.

<sup>66</sup> Curative allocations may occur because the ceiling rule may limit tax deductions generated by the contributed property. The ceiling rule provides that the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. Reg. § 1.704-3(b)(1).

<sup>67</sup> Reg. § 1.704-3(c)(1).

QBU, it is unclear how or whether the 2006 Proposed Regulations would affect the allocations. It is also unclear whether the curative allocation might constitute a contribution to or distribution from the section 987 QBU for FEEP method purposes or might be a remittance for purposes of calculating the owner's recognized currency gain or loss. Example 1 in the Appendix provides an illustration of these issues.

As a second illustration, assume that a partnership with multiple section 987 QBUs or a single section 987 QBU and certain non-QBU assets makes a distribution to a partner. Under certain circumstances, section 734 allows or requires that the partnership adjust the basis of retained assets. If non-QBU assets are distributed and there is a substantial basis reduction as defined in section 734(d), or if a section 754 election is in effect, it is unclear whether the partnership may increase the basis of the section 987 QBU assets in the same class as the distributed asset. In this connection, we note that section 755 determines the allocation of basis when there is a basis adjustment under section 734(b) and those rules do not distinguish between section 987 marked and non-marked assets.

These are two illustrations of the many rules of subchapter K that require or assume that the partners have joined together in a venture and have pooled their contributions to share the income or loss generated by the venture. Other examples include the capital accounting rules of section 704(b), the liability sharing rules of section 752, the basis adjustments prescribed by section 743(b) and allocated among assets under section 755, and the rules of section 751(b) relating to changes in the partners' shares of partnership "hot assets"<sup>68</sup> that may be affected by a distribution from the partnership. Although we understand that that the 2006 Proposed Regulations provide that "transfers" among section 987 QBUs and non-QBUs held in a single partnership are disregarded for purposes of items taken into account under 2006 Proposed Regulation section 1.987-3 (determining the section 987 taxable income or loss of an owner of a section 987 QBU),<sup>69</sup> the rules of subchapter K may affect the composition of the section 987 QBU and, as a result, the calculation of foreign currency gain or loss under the 2006 Proposed Regulations.

Moreover, it appears that certain transfers within a single partnership may constitute a remittance for purposes of section 987 that may trigger recognition of foreign currency gain or loss.<sup>70</sup> To the extent that subchapter K permits partners to share assets and liabilities pooled in a partnership and to readjust those shares without incurring immediate tax consequences, it is not clear that the implementation of section 987 should override this statutory treatment.

2. An entity approach, on the other hand, is consistent with the treatment of a partnership as a joint undertaking and, as noted above, is consistent with existing law. Under a full entity approach, first, each partnership would have its own functional currency that applies to all partnership items. This is consistent with the Tax Equity and Fiscal Responsibility Act ("TEFRA")<sup>71</sup> audit scheme that provides for a single, partnership-level audit for partnership

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<sup>68</sup> "Hot assets" are defined in section 751(c) and (d).

<sup>69</sup> See 2006 Prop. Reg. § 1.987-2(c)(2).

<sup>70</sup> See e.g., 2006 Prop. Reg. § 1.987-2(c)(9), example 5; 2006 Prop. Reg. § 1.987-8(e), example 5; 2006 Prop. Reg. § 1.987-5(c) (definition of a remittance).

<sup>71</sup> Pub. L. No. 97-248, § 402, 96 Stat. 324, 648-67 (codified as amended at §§ 6221-32).

items. This is also consistent with the general rule provided in section 702 that a partnership's income is calculated at the partnership level. We believe a partnership should be permitted to have a functional currency to comply with these statutory requirements. Second, section 987 gain or loss would be a partnership item whenever a partnership holds another section 987 QBU with a different functional currency. That other section 987 QBU might be a true branch or a disregarded entity with a trade or business separate from the partnership and accounted for in a different functional currency, or an interest in a lower-tier partnership.

3. We believe the application of the 2006 Proposed Regulations to partnerships will be administratively burdensome. The 2006 Proposed Regulations require considerable recordkeeping with respect to each section 987 QBU and, because the section 987 QBU is not necessarily co-extensive with the partnership itself, the books and records required by subchapter K will not be sufficient for these purposes. Thus, compliance with the 2006 Proposed Regulations will add to the expense and complexity of compliance with the tax laws. We request that Treasury and the Service reconsider the relative benefits and burdens of the partnership regime in the 2006 Proposed Regulations.

Specifically, under the 2006 Proposed Regulations, partnerships would be required to provide each partner with balance sheet information, stated in the partnership's functional currency, reflecting the partner's share of every partnership asset and liability as well as detailed information with respect to the dates on which historic assets (*e.g.*, fixed assets, inventory, intangible assets) were originally placed in service. Each partner would then be required to translate the information provided into the partner's functional currency, which may differ from partner to partner, to apply the FEED method.

Partnerships would be required to provide similar detailed information to each partner to allow the partner to translate its share of the partnership's taxable income or loss from the partnership's functional currency to the functional currency of the partner, which again may differ from partner to partner. Such information would include dates on which historic assets were acquired, and historic information related to a variety of asset sale transactions (*e.g.*, sales of historic assets, marked assets, and nonfunctional currency denominated assets all are subject to special translation regimes that would require the partnership to provide historic information to each partner so that the partner could translate its distributive share of partnership items into its functional currency). Even less than five percent partners eligible to elect not to compute section 987 gain or loss under the *de minimis* rule of the 2006 Proposed Regulations would be required to translate the partnership's taxable income into the partner's functional currency. Example 2 in the Appendix illustrates the difficulty of complying with the 2006 Proposed Regulations in the partnership context.

A partner in an upper-tier partnership may not control that partnership and may not have any direct relationship with lower-tier entities. As a result, a partner in an upper-tier partnership may have difficult obtaining timely, accurate, and complete information regarding lower-tier entities. In the context of tiered partnerships, using an entity approach, whenever an upper-tier partnership has a functional currency different from a lower-tier partnership in which it is directly invested, the section 987 gain or loss with respect to each lower tier partnership would be determined at the partnership level. A lower-tier partnership would compute its income in its

functional currency, which would be translated into the functional currency of the upper-tier partnership under the section 987 translation rules and included with the upper-tier partnership's own taxable income measured in its functional currency. The upper-tier partnership would account for section 987 gain or loss with respect to its interest in the lower tier partnership and would include section 987 gain or loss in the upper tier partnership's taxable income when partnership distributions are made to the upper tier partnership. Although this is burdensome and complicated, it is significantly less so than the aggregate approach in the 2006 Proposed Regulations.

4. We believe treating a partnership as a per se QBU is consistent with the intent of section 987.<sup>72</sup> We also believe treating a partnership as a per se QBU does not present abuse potential that requires using an aggregate approach and attempting to redefine many of the entity-level calculations of subchapter K to provide aggregate treatment of the entity's activities. If the partnership has investment assets, such as portfolio stock or interests in another partnership, those assets may form an integral part of the partnership's business activities by providing liquidity, collateral for debt used in the trade or business, or reserves for the needs of the business. The 2006 Proposed Regulations require that these business assets be segregated and treated differently for purposes of section 987, a result that appears to be inconsistent with the economic arrangement. If there is an abuse potential related to respecting the partnership as a QBU, we suggest that the Regulations, when finalized, identify the potential abuse and provide special treatment for the potentially abusive arrangement.

5. Finally, the rules relating to allocation of assets and liabilities to a partner's section 987 QBU are ambiguous. When a partner contributes cash or property to a partnership, to the extent section 704(c) is not applicable, the partner "exchanges" a portion of the partner's interest in the contributed property for an undivided interest in the partnership's property. The partner's interest in partnership assets and liabilities may vary asset by asset, may vary depending upon whether profit is earned or losses are suffered, and may vary over time. The 2006 Proposed Regulations attempt to use an aggregate approach to partnerships that assumes a partner's share of each partnership asset can be determined and maintained on a balance sheet and that the partner has access to the information required to maintain the balance sheet even in tiered partnership arrangements, which, as discussed above, may not be the case. The approach of the 2006 Proposed Regulations is to treat the section 987 QBU of a partner as akin to branch activity and to ignore tiered partnerships. Common partnership arrangements are neither static nor easily segregated with respect to each partner and, as noted above, information from lower tier partnerships may not be readily available.

For example, assume that A and B are partners in PRS. PRS owns business X and business Y. A is entitled to 90% of the profits from business X and B is entitled to the other ten percent. A is entitled to ten percent of the profits from business Y and B is entitled to the other 90%. This arrangement applies for the first six years and then the percentages are to flip (*i.e.*, after year six, A will be entitled to ten percent of the profits from business X and 90% of the profits from business Y and B will be entitled to 90% of the profits from business X and ten percent of the profits from business Y). It is unclear under the 2006 Proposed Regulations whether this allocation means that B is treated as owning 90% of business Y for the initial six

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<sup>72</sup> See, *e.g.*, 1986 Bluebook, *supra* note 6, at 1090.

years and A is treated as owning 90% of business X for the same period with a shift on the sixth anniversary, or how A and B should analyze the “benefits and burdens” that they may have in PRS assets that are, for all other purposes, treated as held by a separate entity. In addition, the partnership may also own assets and incur liabilities that are common to both business X and Y that must be allocated between the partners’ section QBU balance sheets.

Continuing with this example, assume the partnership agreement is amended in a later year so that the partners share all items equally. Under the 2006 Proposed Regulations, it is unclear whether this amendment results in deemed transfers for purposes of section 987 between the section 987 QBUs, or between the partners and the section 987 QBUs, and whether this adjustment of partners’ shares, which is common, would trigger remittance treatment under the 2006 Proposed Regulations.

Finally, if instead of owning PRS directly, A and B own interests in an upper-tier partnership that owns an interest in PRS either directly or through other partnerships, the 2006 Proposed Regulations appear to require A and B to have access to the information required to maintain section 987 QBU balance sheets with respect to the lower-tier partnership activities. Not only is this information not readily ascertainable when A and B own a partnership directly, it may be unavailable when businesses are owned through tiers of partnerships.

The 2006 Proposed Regulations provide that a partner determines the partner’s section 987 QBU in a manner that is consistent with the manner in which the partners have agreed to share the economic benefits and burdens (if any) corresponding to the assets and liabilities, taking into account the rules and principles of sections 701 through 761, and the applicable Regulations, including section 704(b) and Regulation section 1.701-2.<sup>73</sup> As illustrated above, given the flexibility and variability of partnership arrangements, this provision does not provide sufficient guidance to assist the partner in determining which partnership assets and liabilities are appropriately included in the partner’s section 987 QBU. Even in the case of section 704(c), Treasury and the Service have indicated that it is uncertain how multiple section 704(c) layers should be determined and maintained.<sup>74</sup> Given the uncertainty in applying even the traditional rules of subchapter K for U.S. tax purposes, we suggest that a rule that mandates segregation of partnership assets and liabilities into separate partner QBUs for section 987 purposes may prove unworkable.

## **2. Translation of partnership liabilities**

Even if the partnership were treated as a section 987 QBU, certain of the translation rules included in the 2006 Proposed Regulations would still be complex and might not provide the correct result. The 2006 Proposed Regulations provide that a partner’s share of partnership liabilities as reflected on the books and records of a section 987 QBU is translated to the partner’s functional currency at specified exchange rates for certain purposes. The 2006 Proposed Regulations provide the following:

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<sup>73</sup> 2006 Prop. Reg. § 1.987-7(b). In 1997, subchapter K was expanded by adding provisions regarding electing large partnerships. After the expansion, subchapter K includes sections 701 through 777.

<sup>74</sup> Notice 2009-70, 2009-34 I.R.B. 255.

1. For purposes of the FEED method of determining the net unrecognized section 987 gain or loss of a section 987 QBU, liabilities are translated from the functional currency of the section 987 QBU to the taxpayer's functional currency at the spot rate.<sup>75</sup>
2. The rules of subchapter K determine the inclusion of liabilities in the section 987 QBU.<sup>76</sup>
3. For purposes of determining gain or loss on the sale, exchange or other disposition of an interest in a section 987 partnership, the amounts of liabilities reflected on the books and records of the taxpayer's portion of a PRS QBU that are included in the amount realized pursuant to section 752(d), are translated using the historic exchange rate for the date on which such liabilities increased the partner's adjusted basis in its partnership interest under section 752.<sup>77</sup>
4. The taxpayer maintains the adjusted basis in a partnership that operates a section 987 QBU in the taxpayer's functional currency.<sup>78</sup>
5. For purposes of translating the section 987 QBU's liabilities to the taxpayer's functional currency for basis purposes, an increase in a partner's share of the liabilities of the partnership is translated at the spot rate and a decrease is translated using the historic rate at which the liabilities increased the partner's adjusted basis in its partnership interest.<sup>79</sup>

The partnership rules relating to the allocation of partnership liabilities are complex and result in frequent shifts of liabilities among the partners for reasons that may be unrelated to changes in the economic arrangement among the partners. Use of these various translation rates will result in significant administrative complexity for both taxpayers and the government. A simple partnership example illustrates the difficulty.

Assume X and Y form LLC (taxed as a partnership) to operate in France. X contributes depreciable property ("Asset A"), with a value of \$100 and an adjusted tax basis of \$20 and Y contributes €100. The partnership borrows €60 secured only by Asset A. No partner is personally liable for the debt. Assume further that Asset A will be depreciated on a straight-line basis over its remaining life of 4 years and that the partners generally share partnership income, gain, loss and deduction equally. At the time of contribution, the exchange rate is \$1 = €1. For purposes of this example, the amount of the debt remains unchanged over the life of the partnership and the assets and liabilities of LLC form a PRS QBU.

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<sup>75</sup> 2006 Prop. Reg. § 1.987-4(d)(4), -4(d)(5); 2006 Prop. Reg. § 1.987-7(d), Ex. 2(ii).

<sup>76</sup> 2006 Prop. Reg. § 1.987-7(b).

<sup>77</sup> 2006 Prop. Reg. § 1.987-7(c)(2)

<sup>78</sup> 2006 Prop. Reg. § 1.987-7(c)(1)(i).

<sup>79</sup> 2006 Prop. Reg. § 1.987-7(c)(1)(iv).

Under Regulation section 1.752-1(a), the debt is nonrecourse and is allocated to X and Y under Regulation section 1.752-3 in three tiers:<sup>80</sup>

1. In *tier 1*, the partner is allocated nonrecourse liabilities equal to his share of partnership minimum gain.<sup>81</sup>
2. In *tier 2*, the partner is allocated an amount of partnership nonrecourse liabilities equal to the partner's section 704(c) minimum gain.<sup>82</sup>
3. In *tier 3*, the partner is allocated nonrecourse liabilities in an amount equal to his share of excess nonrecourse liabilities (those not allocated in tiers 1 or 2).<sup>83</sup>

As Asset A is depreciated by the partnership, its book value and adjusted tax basis are reduced. As illustrated in Example 3 in the Appendix, the changes in book value and tax basis of Asset A have a direct effect on the partners' shares of the debt and, as a result, an effect on the partners' bases in the partnership. As a result of the reduction in book and tax basis of Asset A, both partners' shares of partnership minimum gain, which is reflected in *tier 1*, change, the contributing partner's share of section 704(c) minimum gain, which is reflected in *tier 2*, changes, and the amount of liabilities remaining after *tier 1* and *tier 2* allocations (excess nonrecourse liabilities) changes, thereby affecting each partner's *tier 3* share of debt.

The rules of section 752 apply to determine which partnership liabilities associated with the PRS QBU are included in the partner's section 987 QBU for purposes of the FEEP method balance sheet. Therefore, each change in the allocation of partnership nonrecourse liabilities under Regulation section 1.752-3 affects the liabilities included in a partner's section 987 QBU and must be appropriately translated both for FEEP method balance sheet and section 705 basis purposes. Moreover, as Example 3 of the Appendix illustrates, the choice of depreciation method affects the allocation of partnership nonrecourse liabilities under section 752.

To add to the complexity, under Regulation section 1.704-3, a partnership may choose different depreciation methods for different assets and for different section 704(c) layers in the same asset and the rules of section 752 may cause partners' debt shares to shift frequently.<sup>84</sup>

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<sup>80</sup> Regulation section 1.752-3(b) permits the partnership to allocate a nonrecourse liability among multiple properties under any reasonable method, up to but not exceeding the fair market value of the property. This example assumes the debt is allocated to Asset A.

<sup>81</sup> Partnership minimum gain is computed by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. Book basis is used for purposes of computing partnership minimum gain. See Reg. § 1.704-2(d)(1), -2(d)(3).

<sup>82</sup> Section 704(c) minimum gain is the gain that would be allocated to the partner under section 704(c) if the partnership made a taxable disposition of the property subject to the nonrecourse liabilities in exchange for no consideration other than relief of such liabilities. See Reg. § 1.752-3(a)(2).

<sup>83</sup> There is some flexibility in making *tier 3* allocations; this example assumes allocations consistent with profit shares. See Reg. § 1.752-2(a)(3).

<sup>84</sup> In this connection, we note that the yearly convention adopted in 2006 Proposed Regulation section 1.987-5(c) for purposes of determining the amount of a remittance does not eliminate the requirement that the partner use multiple exchange rates to adjust the partner's basis in the partnership for increases and decreases in the partner's share of partnership liabilities under the rules of 2006 Proposed Regulation section 1.987-7(c)(1)(iv).

Example 3 in the Appendix illustrates the complexity associated with only one asset, one section 704(c) layer, and an annual change in the allocation of partnership liabilities.

Although we understand the interest of Treasury and the Service in accurately measuring a partner's section 987 gain or loss, we suggest that Treasury and the Service consider these complex calculations when determining whether to finalize the 2006 Proposed Regulations rules for a partner's section 987 QBU and the FEED method of determining the partner's pool of unrecognized section 987 gain or loss.

In addition, we request that guidance be provided for common situations that have not been addressed in the 2006 Proposed Regulations. For example, the 2006 Proposed Regulations do not include guidance on whether each change in the allocation of partnership liabilities under section 752 is treated as a deemed distribution of the entire debt at the historic rate or whether only the incremental difference is to be accounted for at the historic rate (if the change is a deemed distribution) or the spot rate (if the change is a deemed contribution).

As another example, the translation rate to be used for purposes of calculating minimum gain and section 704(c) minimum gain (for purposes of the allocation of liabilities under Regulation section 1.752-3) is uncertain under the 2006 Proposed Regulations. Generally, minimum gain calculations require that the security for nonrecourse debt be treated as sold for the amount of the debt. The 2006 Proposed Regulations provide that the amount realized on the sale of a non-marked asset is translated at the yearly average exchange rate or, at the taxpayer's election, the spot rate,<sup>85</sup> and the basis of non-marked assets is translated at the historic exchange rate.<sup>86</sup> We are uncertain of the appropriate translation rate for book basis. We illustrate the potential problem with a calculation of section 704(c) minimum gain, using information from Example 3 in the Appendix.

To calculate section 704(c) minimum gain, the partner is treated as disposing of the built-in gain asset solely in exchange for the amount of the liability to which it is subject. In the first segment of Example 3 in the Appendix, Asset A is depreciated using the traditional method under Regulation section 1.704-3(b). When Asset A was contributed there was only \$40 of section 704(c) minimum gain and \$80 of total built-in gain. At the end of Year 1, Asset A's book value is €75 and its adjusted tax basis is €15<sup>87</sup> in the PRS QBU functional currency. The partnership debt remains at €60 in the PRS QBU functional currency.

Assume that the applicable exchange rate for purposes of translating the amount realized on a disposition of Asset A in exchange for the debt is: \$2 = €1. At that exchange rate, the partnership debt is valued at \$120. If a section 704(c) minimum gain calculation is performed in the functional currency of the section 987 QBU, Asset A is treated as exchanged solely for the amount of the debt and the partner would have gain of €45. That amount is translated at the current rate to \$90. If the minimum gain calculation is computed in U.S. dollars using the

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<sup>85</sup> 2006 Prop. Reg. § 1.987-3(b)(2)(ii)(A).

<sup>86</sup> 2006 Prop. Reg. § 1.987-3(b)(2)(ii)(B)(1). In contrast, the amount realized as a result of the relief of liabilities on the sale of a partnership interest under section 704(d) is translated to the taxpayer's functional currency at the historic rate.

<sup>87</sup> Note that the historic exchange rate is used for purposes of depreciation of non-marked assets.

translation rates provided in the 2006 Proposed Regulations, section 704(c) minimum gain is \$105.<sup>88</sup>

We believe the results using the translation rate provided in the 2006 Proposed Regulations are not correct. The purpose of minimum gain is to ensure that the partners that obtained the tax benefit of the deductions that reduced basis below the level of the debt are charged with the tax detriment if the property is disposed of for the amount of the debt. Because the marked item, debt, is translated to dollars using a variable rate while the security for the debt is translated using the historic rate, the amount of minimum gain calculated using these translation rates distracts from and disturbs the liability allocations based on minimum gain and the allocation of minimum gain chargeback amounts that are required to ensure that the purpose of the minimum gain rule is achieved.

We believe that, if the approach of the 2006 Proposed Regulations is adopted, Treasury and the Service will need to provide additional guidance to coordinate the translation rates and the FEED method rules with the many calculations required by subchapter K. As above, however, we suggest that Treasury and the Service consider simplification of the partnership provisions.

### **3. Section 752 liabilities in a partner's section 987 QBU**

As discussed above, the 2006 Proposed Regulations provide for the FEED method of calculating foreign exchange gain or loss of a section 987 QBU for purposes of section 987. This method uses a balance sheet approach to identify exchange gain or loss for "marked items." Partnership liabilities are treated as "marked items" and the 2006 Proposed Regulations provide that a partner's share of partnership liabilities for purposes of QBU balance is determined under section 752. This treatment of liabilities raises a number of questions.

Use of the debt allocation rules of section 752 for purposes of the section 987 balance sheet may cause tax results that may not reflect a partner's true section 987 exchange gain or loss. This approach may also cause the treatment of a partner that holds a section 987 QBU to vary widely from the treatment of a direct owner of a section QBU branch. We do not believe the debt allocation rules of section 752 are intended to measure a partner's section 987 gain or loss. Rather, we believe they are intended to provide the appropriate partners with basis for purposes of deductions associated with partnership liabilities. We do not believe that providing the appropriate basis in a partnership interest is especially relevant to the partner's exposure to section 987 gain or loss.

A partner's share of liabilities may depend on the method of depreciation and the choice of allocations for excess nonrecourse liabilities or on an economic risk of loss analysis under Regulation section 1.752-2, which assumes that all partnership assets are valueless. Under the balance sheet method adopted in the 2006 Proposed Regulations, it is possible that a partner's unrecognized section 987 gain or loss pool may vary depending on changes in the partner's share of partnership liabilities, which are not allocated based on the partner's exposure to currency

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<sup>88</sup> The current U.S. dollar value of the debt \$120-\$15 (basis translated at historic rate) is \$105.

gains and losses. Thus, there is a disconnect between the subchapter K rules for allocating liabilities and the partner's unrecognized section 987 gain or loss.

In addition, the treatment of even a relatively simple partnership arrangement may differ from that of direct ownership of a section 987 QBU. Although the owner of a section 987 QBU branch is allocated 100% of the section 987 QBU's liabilities, a partner's share of partnership liabilities under section 752 may vary from zero to 100%, depending upon a variety of factors. Thus, we do not believe that the business decisions that may alter the allocation of partnership liabilities are fully considered in the 2006 Proposed Regulations. Example 4 in the Appendix demonstrates that under the 2006 Proposed Regulations a guarantee of a partnership liability provides significantly different result than a guarantee by a direct owner of a section 987 QBU of that same liability. It is unclear whether this difference should exist, particularly if the guarantor never has to perform on the guarantee. We recommend that when the Regulations are finalized Treasury and the Service seek to provide more administrable and economically accurate results for partnership liabilities.

#### **4. Response to request for comments**

In the preamble to the 2006 Proposed Regulations, Treasury and the Service requested comments with respect to a number of additional issues, including whether the Regulations, when finalized, should provide a safe harbor for the allocation of assets and liabilities to the section 987 QBU held by a partnership, how capital accounts should be adjusted under section 704 to take into account section 987 gain or loss, whether section 987 loss should be limited to the partner's basis in the partnership interest, and how section 988 should operate in connection with the assumption of a partner's liability denominated in a functional currency different from the partner's functional currency.

We have not addressed these issues in these Comments because we are uncertain of the rules that would apply to coordinate the pooling approach of subchapter K with the aggregate approach of the 2006 Proposed Regulations and we have recommended that the approach of the 2006 Proposed Regulations be reevaluated. We would be pleased to work with Treasury and the Service to develop effective rules for coordination of the rules under section 987 with subchapter K.

#### **F. Other Comments**

##### **1. The definition of remittance should be less broad**

Under the 2006 Proposed Regulations, an owner recognizes section 987 gain or loss in an amount equal to the product of the owner's net unrecognized section 987 gain or loss of the section 987 QBU determined on the last day of the taxable year, multiplied by the owner's remittance proportion for the taxable year.<sup>89</sup> The remittance proportion is equal to the remittance divided by the sum of (i) the total adjusted basis of the section 987 QBU's gross assets (translated into the owner's functional currency) generally determined as of the end of the

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<sup>89</sup> 2006 Prop. Reg. § 1.987-5(a).

taxable year, and (ii) the remittance.<sup>90</sup> The 2006 Proposed Regulations define a remittance as the net amount transferred from the section 987 QBU to the owner during the taxable year, generally determined as of the last day of the owner's taxable year.<sup>91</sup>

Arguably, a remittance should be limited to the branch equivalent of a dividend—a distribution out of the earnings of the section 987 QBU to its owner.<sup>92</sup> If that is the case, then the definition of a remittance in the 2006 Proposed Regulations is too broad. For example, movements of cash from a section 987 QBU to its owner in exchange for property would be treated as a remittance, even though that is not a distribution out of the section 987 QBU's earnings. On the other hand, we acknowledge that the annual netting rule of the 2006 Proposed Regulations may reduce (or even eliminate) this distinction in many cases. Assume a euro section 987 QBU buys inventory from its U.S. dollar owner. The section 987 QBU pays \$105 for the inventory, in which the owner has a \$100 basis. Under 2006 Proposed Regulation section 1.987-5(c), the section 987 QBU has remitted only \$5, not the entire \$105 of cash paid. Although this amount is not necessarily paid out of the section 987 QBU's earnings, some value approximating \$5 has moved from the section 987 QBU to the owner.

Although the annual netting rule<sup>93</sup> will mitigate the impact of a broad definition of remittance in the context of an otherwise disregarded purchase and sale of goods between a section 987 QBU and its owner, it does not help in certain other situations. Assume the euro section 987 QBU is not “buying” inventory from its owner for \$105, but instead is paying its owner \$105 for services the owner provided to the section 987 QBU. Because those services are not assets or liabilities, they are not included in the netting required under the 2006 Proposed Regulations. Instead, the section 987 QBU would be viewed as having made a remittance of the entire \$105, notwithstanding that it clearly received substantial value in exchange for that payment.

Given the breadth of the definition of remittance, we recommend that the final Regulations adopt an ordinary course exception pursuant to which arm's-length transactions between the owner and the section 987 QBU, and among section 987 QBUs of the same owner, would not be taken into account in determining the amount of a remittance. Excepted transactions could include sales of goods or the performance of services among these parties. When these transactions occur in the ordinary course of business, and at arm's-length, we believe recognition of exchange gain or loss should not occur. This exception would not result in the permanent exclusion of any section 987 gain or loss; it would merely affect the timing of recognition. Any section 987 gain or loss not recognized as a result of such ordinary course transactions would be recognized when the owner terminates or otherwise receives distributions from the section 987 QBU.

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<sup>90</sup> 2006 Prop. Reg. § 1.987-5(b).

<sup>91</sup> 2006 Prop. Reg. § 1.987-5(c).

<sup>92</sup> Section 987(3) provides that the taxable income of a taxpayer owning one or more QBUs shall be determined by “treating post-1986 remittances from each such unit as made on a pro rata basis out of post-1986 accumulated earnings . . . .”

<sup>93</sup> 2006 Prop. Reg. § 1.987-5(c).

## 2. Offsetting positions

The 2006 Proposed Regulations include offsetting positions as a factor indicating tax avoidance when one leg of the position is not recorded on the section 987 QBU's books and records. Specifically, the 2006 Proposed Regulations state:

relevant factors which may indicate that a principal purpose of recording (or failing to record) an item on the books and records of an eligible QBU is the avoidance of U.S. tax under section 987 are. . . (C) The presence or absence of an item on the books and records that results in the taxpayer (or person related to the taxpayer as defined in section 269(b) or 707(b)) having offsetting positions in the functional currency of a section 987 QBU.<sup>94</sup>

If a section 987 QBU engaged in lending is funded with third party debt or related party debt (from other than its owner), section 987 would take into account the asset (*e.g.*, cash or loan receivable) and the related liability in the hands of the section 987 QBU. On the other hand, if the owner borrows funds denominated in its section 987 QBU's functional currency and contributes the loan proceeds to its section 987 QBU in a disregarded transaction, section 987 would take into account only the resulting asset, not the associated liability, because the liability would not be reflected in the books and records of the section 987 QBU.<sup>95</sup> The 2006 Proposed Regulations treat this transaction as indicative of tax avoidance.<sup>96</sup> Although we agree that in some instances such a transaction may be indicative of tax avoidance, we suggest that Treasury and the Service provide additional guidance on this issue in the context of a section 987 QBU conducting a finance or banking business. We also suggest that Treasury and the Service clarify that the example in the 2006 Proposed Regulations does not involve such a section 987 QBU.<sup>97</sup> Given the financing needs of a section 987 QBU conducting a finance or banking business, which are frequently dictated by regulatory requirements, there could be many transactions that trigger factors indicating tax avoidance. In light of this, additional guidance on when such transactions indicate tax avoidance would be helpful to taxpayers and the Service.

Also, in the context of a partnership, a partner's share of the assets and liabilities of a section 987 QBU might vary by asset and by liability or might be pro rata. If the shares are pro rata, the arrangement will maintain equal and offsetting positions for each partner. If the shares are not pro rata, a portion of each partner's section 987 QBU will include offsetting positions. Because this result reflects the economics adopted by the aggregate approach of the 2006 Proposed Regulations, it is unclear that such a result is abusive. Thus, we suggest that Treasury and the Service provide additional guidance on this issue in the context of a section 987 partnership, especially if the decision is made to retain the aggregate approach.

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<sup>94</sup> 2006 Prop. Reg. § 1.987-2(b)(3)(iii) (relating to factors indicating that items were recorded in the books of a section 987 QBU with a principal purpose of avoiding U.S. tax under section 987).

<sup>95</sup> 2006 Prop. Reg. § 1.987-2(b)(1), -2(c)(2)(i).

<sup>96</sup> 2006 Prop. Reg. § 1.987-2(b)(3)(iii), -2(c)(9), Ex. 15.

<sup>97</sup> See 2006 Prop. Reg. § 1.987-2(c)(9), Ex. 15.

### 3. Determination of net unrecognized section 987 gain or loss

The 2006 Proposed Regulations provide a seven-step process for calculating the unrecognized section 987 gain or loss of a section 987 QBU for a particular taxable year.<sup>98</sup> The first step is to determine the change in the owner functional currency net value (or “FCNV”) of the section 987 QBU. This change in value is in the first instance considered attributable to fluctuations in the value of the owner’s functional currency *vis a vis* the section 987 QBU’s functional currency, and thus is the foundation of any unrecognized section 987 gain or loss for the year.

Circumstances other than mere changes in exchange rates may affect the change in the net value of a section 987 QBU, so the 2006 Proposed Regulations adjust this amount to take into account those circumstances. For example, even if exchange rates do not change during the course of the year, the owner FCNV will decrease to the extent of assets transferred from the section 987 QBU to its owner during the course of the taxable year. The 2006 Proposed Regulations therefore increase the amount computed in the first step by the amount of any such transfer. Similarly, that amount is decreased by the amount of any property transferred from the owner to the section 987 QBU.

An adjustment is also required for any section 987 taxable income or loss of the section 987 QBU includible by the owner under the 2006 Proposed Regulations.<sup>99</sup> Without this adjustment, any such income or loss could be double counted. Again assume a euro section 987 QBU and a U.S. dollar owner. At the beginning of the year, the section 987 QBU owns €100 of assets, and the owner’s FCNV of the section 987 QBU is \$100. Assume further that the section 987 QBU earns €20 of income, which the owner translates into \$30 of taxable income under the 2006 Proposed Regulation section 1.987-3. Finally, assume that at the end of the year the section 987 QBU owns €120 (the original €100 of assets plus €20 in cash reflecting the income it earned), the owner functional currency value of which is \$180.

Under step one of the seven-step process,<sup>100</sup> the change in the owner FCNV of the section 987 QBU for the year is \$80 (\$180 - \$100). Absent any adjustments, that amount would be the unrecognized section 987 gain for the year. The owner is also required to include in income currently its \$30 of taxable income from the section 987 QBU computed under 2006 Proposed Regulation section 1.987-3. Thus, for the taxable year the owner would have a total of \$110 of recognized and unrecognized income from its section 987 QBU. But this is too much; \$30 of the change in the net value of the section 987 QBU is attributable to the \$30 (€20) of assets reflecting the income earned by the section 987 QBU and included by the owner, not to mere changes in exchange rates. Accordingly, step seven of the process decreases the amount determined in step one by “the section 987 taxable income of the section 987 QBU for the taxable year.”<sup>101</sup>

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<sup>98</sup> 2006 Prop. Reg. § 1.987-4(d)(1)-(7).

<sup>99</sup> 2006 Prop. Reg. § 1.987-3.

<sup>100</sup> 2006 Prop. Reg. § 1.987-4(d)(1).

<sup>101</sup> 2006 Prop. Reg. § 1.987-4(d)(7).

We agree that this type of adjustment is necessary. We note, however, that adjusting the change in the owner FCNV of the section 987 QBU for “the section 987 taxable income” of the section 987 QBU may still produce incorrect results when taxable income is different from cash income or earnings and profits. In addition to the facts above, assume that the section 987 QBU also pays €6 of local country tax that is not deductible at the section 987 QBU level under U.S. tax principles. The owner would still include the \$30 (€20) of income currently. The section 987 QBU’s net assets, however, would only have increased by €14 (€20 - €6). Under step one, the change in the owner FCNV of the section 987 QBU would be \$71 (\$171 (€114 x 1.5) - \$100). Under step seven, this would be reduced by the section 987 taxable income of the owner, \$30. The remaining \$41 would be unrecognized section 987 gain. This is the result under the 2006 Proposed Regulations even though the U.S. dollar has depreciated by 50% during the year, such that the owner functional currency value of the section 987 QBU’s assets at the beginning of the year (€100) has actually increased by \$50, not \$41.

We therefore recommend that steps six and seven<sup>102</sup> be amended so that the amounts computed in the previous steps are adjusted not by any section 987 taxable loss or income of the section 987 QBU for the taxable year as determined under the 2006 Proposed Regulations,<sup>103</sup> but rather by any reduction or increase (as the case may be) in the owner functional currency amount of any section 987 QBU earnings and profits for that year.

#### 4. Transitional Issues

The 2006 Proposed Regulations provide two regimes for transitioning taxpayers to the proposed rules. Under the first method, the “deferral transition method,” the taxpayer assumes that all of its section 987 QBUs terminate immediately prior to the first day that the 2006 Proposed Regulations apply to the taxpayer. The resulting section 987 gain or loss, determined under the taxpayer’s existing method for complying with section 987, for each section 987 QBU is not recognized but rather is treated as net unrecognized section 987 gain or loss of such section 987 QBU in the first taxable year in which the 2006 Proposed Regulations are effective.<sup>104</sup> The second method, the fresh start transition method, is similar to the first, except that no section 987 gain or loss is determined on the deemed termination date.<sup>105</sup> In both cases, a taxpayer (including a consolidated group) must use the same transition method for each of its section 987 QBUs, as well as the section 987 QBUs of any controlled foreign corporations in which the taxpayer owns more than 50% of the voting power or stock.<sup>106</sup> Taxpayers may not use the deferral transition method if their prior section 987 method is deemed unreasonable.<sup>107</sup>

Under either transition method, taxpayers generally are required to use historic exchange rates for determining the amount of assets and liabilities transferred from the taxpayer owner to the section 987 QBU.<sup>108</sup> Under the deferral transition method, however, taxpayers adjust the exchange rate used to determine the amount of assets and liabilities transferred to their

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<sup>102</sup> 2006 Prop. Reg. § 1.987-4(d)(6)-(7).

<sup>103</sup> 2006 Prop. Reg. § 1.987-3.

<sup>104</sup> 2006 Prop. Reg. § 1.987-10(c)(3)(i).

<sup>105</sup> 2006 Prop. Reg. § 1.987-10(c)(4)(i).

<sup>106</sup> 2006 Prop. Reg. § 1.987-10(c)(2).

<sup>107</sup> 2006 Prop. Reg. § 1.987-10(a)(2).

<sup>108</sup> 2006 Prop. Reg. § 1.987-10(c)(3)(ii), -10(4)(ii).

section 987 QBU to account for any net unrecognized section 987 gain or loss arising from the deemed termination.<sup>109</sup> In the case of a taxpayer that has treated all of its section 987 QBU's assets and liabilities as being subject to section 987 gain or loss, the taxpayer would use the same rate used to determine the unrecognized section 987 gain or loss on the date of the deemed termination.<sup>110</sup>

Depending on its prior section 987 method, a taxpayer may find the deferral transition method more attractive because it does not require tracing the historic exchange rates relating to section 987 QBU assets and liabilities. A taxpayer also may find the deferral transition method more attractive if the taxpayer has historic exchange losses. Given the limitation and conformity rules in the 2006 Proposed Regulations, however, some taxpayers would not be eligible to elect the deferral transition method if the Regulations were finalized as proposed. We suggest that Treasury and the Service consider broadening the deferral transition method to permit a taxpayer that has reasonably complied with the section 987 rules to qualify for the method, even if some of its section 987 QBUs have incorrectly applied section 987. In addition, we suggest that the 2006 Proposed Regulations provide some examples of reasonable allocation methods in those cases in which a taxpayer is unable to trace an exchange rate to a particular asset or liability. Finally, we note that the assets included in the examples of the application of the transition methods in the 2006 Proposed Regulations only include assets acquired when the relevant funds were contributed or earned.<sup>111</sup> We suggest that Treasury and the Service revise the examples to include assets that generally "turn" frequently and to confirm that a permanent difference may result from the application of a particular transition method even though the change to the FEED method is treated as a change in accounting method under the 2006 Proposed Regulations.

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<sup>109</sup> 2006 Prop. Reg. § 1.987-10(c)(3)(ii).

<sup>110</sup> 2006 Prop. Reg. § 1.987-10(d), Ex. 1 (taxpayer applying 1991 Proposed Regulations).

<sup>111</sup> See 2006 Prop. Reg. § 1.987-10(d), Examples 1-3.

## APPENDIX

### Example 1 – Curative Allocations

G and H (both US persons) form partnership GH in Germany and agree that each will be allocated a 50% share of all partnership items and that GH will make allocations under section 704(c) using the traditional method with curative allocations. GH operates business X in Germany. Business X is a section 987 QBU that uses the euro as its functional currency. GH also holds a disregarded entity LLC that is not part of business X. LLC engages in a trade or business in England. G contributes property G1, with an adjusted tax basis of \$3,000 and a fair market value of \$10,000, and H contributes property H1, with an adjusted tax basis of \$6,000 and a fair market value of \$10,000. For good business reasons, Property G1 is used in business X and Property H1 is contributed to LLC.

Both property G1 and property H1 have five years remaining on their cost recovery schedules and are depreciable using the straight-line method. At the time of contribution, G1 has built-in gain of \$7,000 and H1 has built-in gain of \$4,000, and therefore, both properties are section 704(c) property. G1 generates \$600 (€600) of tax depreciation and \$2,000 (€2,000) of book depreciation for each of five years. H1 generates \$1,200 of tax depreciation and \$2,000 of book depreciation for each of five years. G and H are each allocated \$10,000 of book depreciation for each property. Under the traditional method, G would be allocated no tax depreciation from G1 and \$1,000 of tax depreciation for H1 and H would be allocated \$600 of tax depreciation for G1 and \$200 of tax depreciation for H1 each year. Because H contributed property with a smaller disparity reflected on GH's book and tax capital accounts, GH would ordinarily make curative allocations to H of an additional \$400 of tax depreciation from H1 to reduce the disparities between G's and H's book and tax capital accounts ratably each year.

If GH (the partnership) were an eligible QBU, those curative allocations would be made in the eligible QBU's functional currency. Under the 2006 Proposed Regulations, because GH is divided into an activity that is an eligible QBU and a portion that is not an eligible QBU, it is unclear whether curative allocations are permitted and, if so, how the allocation would be treated under the new balance sheet method.

## Example 2 – Multiple Partners and Transactions

The facts of this example are slightly more complicated than the examples in the 2006 Proposed Regulations, but these facts are much less complicated than situations that commonly arise in practice. For example, in the following fact pattern, all allocations of partnership items are made in proportion to the partners' capital accounts. Nevertheless, this example illustrates that in a partnership with multiple partners and multiple transactions, all of which are undertaken for valid business reasons, the approach of the 2006 Proposed Regulations is burdensome.

### Facts

On December 31, 2010, partnership PRS has ten partners ("P1" through "P10"). P2 through P10 are all U.S. individuals or domestic corporations. P1 is a partnership with three partners, all of whom are individuals or corporations ("U1", "U2," and "U3"). Assume that based on the relative size of their indirect interests, U1, U2, and U3 do not qualify for the *de minimis* rule in the 2006 Proposed Regulations.<sup>112</sup>

PRS owns two businesses ("A" and "B") that are treated as PRS QBUs with respect to each direct or indirect partner that is not a partnership (*i.e.*, P2 through P10 and U1 through U3). Businesses A and B each have 100 assets and do not use the same functional currency as any of the direct or indirect partners. PRS also owns 100 investment assets that properly are not treated as part of an eligible QBU.

PRS allows partners to join and leave the partnership only on the last day of each calendar month. In each of the first six months of 2011, PRS admits one new partner. Each partner contributes cash for its interest. On July 1, 2011, there are 16 direct partners in PRS (P2 through P16).

On August 31, 2011, PRS distributes cash from its non-QBU assets to P2 in liquidation of P2's interest. On September 30, 2011, PRS distributes cash from its non-QBU assets to P3 in liquidation of P3's interest. On October 31, 2011, PRS distributes cash from its non-QBU assets to P4 in liquidation of P4's interest. At the time of each distribution, PRS has ordinary income assets, and part of the ordinary income inherent in these assets would be allocated to each of the departing partners if the assets were sold for their fair market values on these dates.

The distributions trigger deemed exchanges under section 751(b). Pursuant to Regulation section 1.751-1(b), PRS is deemed to distribute ordinary income assets to P2, P3, and P4. P2, P3, and P4 then are deemed to exchange those ordinary income assets for a portion of the cash distributed to each partner. Finally, PRS is treated as distributing the remaining cash to P2, P3, and P4 in redemption of their interests.

Assume, for discussion purposes, that P2, P3, and P4 recognize gain under section 731 as a result of these distributions, and that PRS increases the basis of partnership property by the amount of that gain under section 754. These basis adjustments are allocated among partnership property under section 755. Thus, for example, if all of PRS's appreciated assets are in business A, then the basis adjustments may be allocated solely to the assets in business A.

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<sup>112</sup> 2006 Prop. Reg. § 1.987-1(b)(1)(ii).

The partners share partnership profits pro rata in proportion to their interests in partnership capital. PRS revalues its property immediately before each of these transactions, creating multiple “reverse” section 704(c) layers and causing each partner to have a different share of taxable income or loss in each of the partnership’s assets.

## **Discussion**

The admission of P11 in January results in deemed transfers to each of the direct or indirect partners of PRS (specifically, P2 through P10, and U1 through U3) from their respective section 987 QBUs under the 2006 Proposed Regulations. Because there are 12 partners and two section 987 QBUs per partner, there are 24 deemed transfers. This analysis is repeated in the next five months, resulting in 26, 28, 30, 32, and 34 deemed transfers, respectively. The six contributions through June 30 result in 174 fictional transfers (the sum of 24, 26, 28, 30, 32, and 34).

Although the 2006 Proposed Regulations do not expressly address the treatment of actual or deemed distributions from a partnership to the partners who are not treated as receiving such distributions, the actual and deemed distributions in August apparently would cause the direct and indirect partners of PRS to be treated as making transfers to their respective section 987 QBUs. Because there are 18 partners and two section 987 QBUs per partner, there are at least 36 deemed transfers (assuming that the “first distribution” and the “second distribution” may be treated as a single event). This analysis is repeated in the next two months, resulting in 34 and 32 deemed transfers, respectively. The three distributions result in 102 fictional transfers.

Even though the partners share economic income in proportion to their capital accounts, the impact, if any, of the section 734(b) adjustments and reverse section 704(c) allocations on the partners’ shares of partnership assets and liabilities, and on the amount of the deemed transfers resulting from the 2006 Proposed Regulations, is uncertain.

## **Compliance with the 2006 Proposed Regulations**

The 2006 Proposed Regulations do not specify what information and reporting requirements may apply to PRS and its direct and indirect partners. In order for all of the parties to comply with the 2006 Proposed Regulations, a substantial amount of information will need to be exchanged. For example, PRS must provide information regarding each partner’s share of every asset in business A (100 assets), business B (100 assets), and its 100 investment assets to each of its 16 direct partners. The information with respect to each asset would include the date on which it was acquired and whether it was a marked or historic asset. PRS also must provide information regarding each partner’s share of each liability of the partnership and the date on which it was incurred. Each partner (other than P1) then must translate each of these items using the exchange rate (historic or current) applicable to each such item. Because each asset may have been acquired on a different date, each partner (other than P1) will be required to determine the exchange rates in effect on up to 300 different dates with respect to each of its businesses. It is unclear how much of this information would be required to be shared with the Service by either the partnership or the partners.

The 2006 Proposed Regulations do not expressly require the partners to provide information regarding their own functional currencies to the partnerships in which they own an interest. If the partners in P1 provide this information to P1, P1 provides information about its partners to PRS, and P2 through P16 provide this information to PRS, then PRS theoretically could use this information to translate each partner's share of assets and liabilities into each partner's functional currency. To the extent that different partners use different functional currencies, the partnership may need to translate the information required by the 2006 Proposed Regulations into many different currencies.

Similar considerations apply to the reporting of a partner's distributive share of partnership income. PRS generally would need to report whether each transaction undertaken during the taxable year represents income from the sale of a historic or marked asset, or some other event, and the date on which the item of income, gain, loss, or deduction was recognized. Each partner (other than P1) then must translate each of these items using the exchange rate (historic or current) applicable to each such item. Because each item of income, gain, loss, or deduction may have arisen on a different date, each partner (other than P1) will be required to determine the exchange rates in effect on up to 365 different dates with respect to each of its businesses.

Presumably, P1 would be required to provide the balance sheet and distributive share information it receives from PRS to each of the partners in P1. It is unclear whether P1 or PRS would be required to allocate and apportion P1's share of PRS assets and liabilities among U1, U2, and U3. If PRS is responsible for making this determination, it is unclear when and how P1 must provide the information necessary for making this determination to PRS. It is also unclear how much of this information would be required to be shared with the Service by either the partnership or the partners. It would be burdensome for the Service to verify that the information is correct and to ensure that the information is handled consistently by the partnership and its partners. In addition, due to the inherent difficulty of applying the principles of subchapter K without more specific guidance, conflicts between partners and partnerships, and between taxpayers and the Service, may arise.

### Example 3 – Effect of Depreciation Methods on Basis

As discussed in Part II.E.2., *supra*, even if the partnership were treated as a section 987 QBU, certain of the translation rules included in the 2006 Proposed Regulations would still be complex and might not provide the correct result. The 2006 Proposed Regulations provide that a partner’s share of partnership liabilities as reflected on the books and records of a section 987 QBU is translated to the partner’s functional currency at specified exchange rates for certain purposes. The partnership rules relating to the allocation of partnership liabilities are complex and result in frequent shifts of liabilities among the partners for reasons that may be unrelated to changes in the economic arrangement among the partners. Use of these various translation rates will result in significant administrative complexity for both taxpayers and the government. The following example illustrates the difficulty.

Assume X and Y form LLC (taxed as a partnership) to operate in France. X contributes depreciable property (“Asset A”), with a value of \$100 and an adjusted tax basis of \$20 and Y contributes €100. The partnership borrows €60 secured only by Asset A. No partner is personally liable for the debt. Assume further that Asset A will be depreciated on a straight-line basis over its remaining life of 4 years and that the partners generally share partnership income, gain, loss and deduction equally. At the time of contribution, the exchange rate is \$1 = €. For purposes of this example, the amount of the debt remains unchanged over the life of the partnership and the assets and liabilities of LLC form a PRS QBU.

#### Results Under the Traditional Method of Depreciation

If Asset A is depreciated under the traditional method under Regulation section 1.704-3(b), X and Y will be allocated the following book and tax depreciation for Asset A over its four remaining years. In total, \$25 book depreciation and \$5 of tax depreciation is taken each year.

##### Traditional Method Asset Basis:

Asset A	<u>Contribution</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
704(b)	100	75	50	25	0
Tax Basis	20	15	10	5	0

##### Traditional Method Depreciation Allocation:

	<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>		<u>Year 4</u>	
	704(b)	Tax	704(b)	Tax	704(b)	Tax	704(b)	Tax
X	(12.5)	0	(12.5)	0	(12.5)	0	(12.5)	0
Y	(12.5)	5	(12.5)	5	(12.5)	5	(12.5)	5

**Nonrecourse Debt Allocations with Tier II determined using the Traditional Method:**

	<u>Contribution</u>		<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>		<u>Year 4</u>	
	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>
<b>Tier I</b>	0	0	0	0	5	5	17.5	17.5	30	30
<b>Tier II</b>	40	0	45	0	40	0	20	0	0	0
<b>Tier III</b>	<u>10</u>	<u>10</u>	<u>7.5</u>	<u>7.5</u>	<u>5</u>	<u>5</u>	<u>2.5</u>	<u>2.5</u>	<u>0</u>	<u>0</u>
<b>Total</b>	50	10	52.5	7.5	50	10	40	20	30	30

**Effect of the Nonrecourse Debt Allocation on the Partner's Basis in their Partnership Interests:**

	<u>Contribution</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
<b>X</b>	20+50	20+52.5	20+50	20+40	20+30
	<b>70</b>	<b>72.5</b>	<b>70</b>	<b>60</b>	<b>50</b>
<b>Y</b>	100+10	95+7.5	90+10	85+20	80+30
	<b>110</b>	<b>102.5</b>	<b>100</b>	<b>105</b>	<b>110</b>

**Results Under the Remedial Method of Depreciation**

The following illustrates the result if instead the remedial method under Regulation section 1.704-3(d) is chosen, and if the excess of book basis over tax basis (80) is depreciated over eight years (10 per year shared equally (five) each):

**Remedial Method Annual Depreciation<sup>113</sup>:**

<b>Asset A</b>	<u>Contribution</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Yrs 5-9</u>
704(b)	100	15	15	15	15	10 (x4)
Tax	20	5	5	5	5	0

**Remedial Method Asset Basis:**

<b>Asset A</b>	<u>Contribution</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Years 5-9</u>
704(b)	100	85	70	55	40	0
Basis						
Tax Basis	20	15	10	5	0	0

<sup>113</sup> See Rev. Rul. 95-41, 1995-1 C.B. 132.

**Remedial Method Depreciation Allocation:**

	<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>		<u>Year 4</u>		<u>Years 5-9</u>	
	704(b)	Tax	704(b)	Tax	704(b)	Tax	704(b)	Tax	704(b)	Tax
X	(7.5)	2.5	(7.5)	2.5	(7.5)	2.5	(7.5)	2.5	(20)	20
Y	(7.5)	(7.5)	(7.5)	(7.5)	(7.5)	(7.5)	(7.5)	(7.5)	(20)	(20)

**Nonrecourse Debt Allocations with Tier II determined using the Remedial Method:**

	<u>Contribution</u>		<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>		<u>Year 4</u>	
	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>
Tier I	0	0	0	0	0	0	2.5 <sup>114</sup>	2.5 <sup>115</sup>	10	10
Tier II	60	0	57.5	0	55	0	50	0	40	0
Tier III	<u>0</u>	<u>0</u>	<u>1.25</u>	<u>1.25</u>	<u>2.5</u>	<u>2.5</u>	<u>2.5</u>	<u>2.5</u>	<u>0</u>	<u>0</u>
Total	60	0	58.75 <sup>116</sup>	1.25	57.5	2.5	55	5	50	10

**Effect of the Nonrecourse Debt Allocation on the Partners' Basis in their Partnership Interests:**

	<u>Contribution</u>		<u>Year 1</u>		<u>Year 2</u>		<u>Year 3</u>		<u>Year 4</u>	
	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>	<u>X</u>	<u>Y</u>
Beginning Basis	20	100	80	100	81.25	93.75	82.5	87.5	82.5	82.5
Income (Losses)	0	0	2.5	-7.5	2.5	-7.5	2.5	-7.5	2.5	-7.5
Less PY Debt	0	0	-60.	-0	-58.75	-1.25	-57.5	-2.5	-55	-5
Plus CY Debt	<u>60</u>	<u>0</u>	<u>58.75</u>	<u>1.25</u>	<u>57.5</u>	<u>2.5</u>	<u>55</u>	<u>5</u>	<u>50</u>	<u>10</u>
Tax Basis	80	100	81.25	93.75	82.5	87.5	82.5	82.5	80	80

<sup>114</sup> If Asset A were sold for debt in the amount of 60, there would be 704(b) minimum gain of \$5 (\$60 - \$55) shared equally and 704(c) gain of \$50 (\$55 - \$5).

<sup>115</sup> If Asset A were sold for debt in the amount of 60, there would be 704(b) minimum gain of \$5 (\$60 - \$55) and 704(c) gain of \$50 (\$55 - \$5).

<sup>116</sup> If Asset A were sold for the liability of \$60, there would be a book loss of \$25 (\$85 book value-\$60) that would be shared equally (\$12.5 each). Because there is no tax loss to allocate to Y, under the remedial allocation method, X would be allocated \$12.5 of remedial income to offset Y's loss + \$45 of minimum gain (\$60 - \$15) or \$57.5. The balance of the \$60 of liability (\$2.5) would be shared equally in tier 3.

#### Example 4 – Branch Compared with Partnership

As explained in Part II.E.3., *supra*, this example demonstrates that under the 2006 Proposed Regulations a guarantee of a partnership liability provides significantly different result than a guarantee by a direct owner of a section 987 QBU of that same liability. It is unclear whether this difference should exist, particularly if the guarantor never has to perform on the guarantee. We recommend that when the Regulations are finalized Treasury and the Service seek to provide more administrable and economically accurate results for partnership liabilities.

#### CORPORATE BRANCH

Assume Corp A operates a section 987 QBU in France through a disregarded entity. Corp A contributes €400 at the beginning of Year 1 and the section 987 QBU borrows €800 (nonrecourse) and uses €1,000 to purchase nondepreciable Prop A. The exchange rate at the time of is €1=\$1. At the end of year 1, the exchange rate is €1=\$2.

QBU's balance sheet at the end of Year 1:

Property A	€1,000	\$1,000
Debt	(€800)	(\$1,600)
Cash	€200	\$400
	€400	(\$200)

The calculation of Corp A's unrecognized section 987 gain or loss is as follows<sup>117</sup>:

Year 1 foreign currency net value (FCNV)	(\$200)
Previous year FCNV	<u>0</u>
	(\$200)
Transfers to QBU (translated at time of transfer)	<u>- \$400</u>
Branch Year 1 foreign exchange loss	(\$600)

#### PARTNERSHIP 1 QBU A and B

Same as above, except that Corp A and Corp B each contribute €200 and the nonrecourse debt is allocated under the third tier of Regulation section 1.704-3 in accordance with profit shares. At the end of Year 1, Corp A and Corp B will each have a section 987 QBU equal to one half of the section 987 QBU branch illustrated above and will each have a net unrecognized foreign exchange loss of (\$300).

#### PARTNERSHIP 2 QBU A and B

<sup>117</sup> Steps one through seven in 2006 Proposed Regulation section 1.987-4(d) explain the calculation of unrecognized section 987 gain or loss for a taxable year. *See also* 2006 Prop. Reg. § 1.987-4(b).

Same as Partnership 1, except that Corp A guarantees the debt. Despite the fact that the guarantee may not be expected to be needed and no payment on the guarantee is expected to be made, in this example, Corp A and Corp B have significantly different results as a result of the guarantee having been made.<sup>118</sup>

Corp A Balance Sheet

Prop A	€500	\$500
Cash	€100	\$200
Debt	<u>(€800)</u>	<u>(\$1,600)</u>
		(\$900)

Corp B Balance Sheet

Prop A	€500	\$500
Cash	€100	\$200
Debt		
		\$700

Year 1

Corp A

Year 1 FCNV	(\$900)
Previous Year FCNV	<u>- 0</u>
	(\$900)
Transfers to QBU	<u>-\$200</u>
Corp A unrecognized foreign exchange loss	(\$1,100)

Corp B

Year 1 FCNV	\$700
Previous Year FCNV	<u>- 0</u>
	\$700
Transfers to QBU	<u>-\$200</u>
Corp B unrecognized foreign exchange gain	\$500

<sup>118</sup> Note that partnerships often do not provide that a partner has an increased interest in security for guaranteed debt, in contrast to example 3 in 2006 Proposed Regulation section 1.987-7(d).