COMMENTS

of

TAX EXECUTIVES INSTITUTE, INC.

on

REG-128276-12

relating to

the Recognition and Deferral of Foreign Currency Gain or Loss Under Section 987 with respect to a Qualified Business Unit

submitted to

The Internal Revenue Service

March 7, 2017

Background

On December 8, 2016, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS" or the "Service") published final regulations under section 987 (the "Final Regulations")[1] related to income and currency gain or loss with respect to a section 987 qualified business unit ("QBU").[2] The Treasury and the IRS also published temporary regulations (the "Temporary Regulations")[3] under section 987 contemporaneously with the Final Regulations. The text of the Temporary Regulations serves as the text of proposed regulations also issued under section 987 on December 8, 2016.[4]

[1] T.D. 9794.

[2] A QBU is defined in section 989 as any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.

[3] T.D. 9795.

[4] REG-128276-12, 81 F.R. 88882 (Dec. 8, 2016). Because the text of the proposed regulations is the same as the Temporary Regulations, we refer to the Temporary Regulations throughout this document.

Treasury and IRS requested comments on these regulations by March 8, 2017. On behalf of Tax Executives Institute, Inc. ("TEI"), I am pleased to respond to the government's request for comments.

Tax Executives Institute

TEI is the preeminent association of in-house tax professionals, worldwide. Our more than 7,000 members represent 2,800 of the leading companies in North and South America, Europe, and Asia. TEI represents a cross-section of the business community, and is dedicated to developing and effectively implementing sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. As a professional association, TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply in a cost-efficient manner.

TEI's members are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the tax law relating to the operation of business enterprises, including complying with complex regulations regarding foreign business activities and currency transactions, such as those under section 987. We believe that the diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues raised by the Final and Temporary Regulations.

TEI Comments

1. Technical Comments

a. Overview

The Final and Temporary Regulations have three main components: (i) temporary regulations establishing loss deferral rules for transactions entered into after January 6, 2017, subject to an anti-abuse rule for tax avoidance transactions occurring after December 6, 2016; (ii) final and temporary regulations providing certain elections, which for calendar year taxpayers may apply, by election, as of January 1, 2017 (*i.e.*, taxable years beginning after December 8, 2016); and (iii) final regulations governing the recognition of income and the establishment of built-in gain and loss accounts, which for calendar-year taxpayers apply as of January 1, 2018. The Final Regulations also set forth transition rules dictating a "fresh-start" method (the "Fresh Start Method") as of the date of adoption.

The Final Regulations create several issues for taxpayers as they adopt the new approach for computing currency gains or losses of section 987 QBUs. Many of these issues require taxpayers to change their tax and accounting systems and processes, as well as dedicate significant amounts of time, resources, and funds to comply with the regulations. The timeline for making changes to a taxpayer's underlying accounting systems may range from 12 months to several years. Indeed, because any changes would be made "solely" for tax compliance purposes – as there are no similar changes required for U.S. GAAP or IFRS – companies may not expend the necessary resources to fully modify their ERP systems. Thus, many taxpayers may track the section 987 calculations required by the new regulations manually, substantially increasing the chances of compliance errors. Even for those taxpayers who choose to modify their systems to comply with the new regulations, the technology system changes may take years, forcing taxpayers to hire additional, temporary resources to be in compliance as of the January 1, 2018, effective date.

Finally, many issues raised by the Final Regulations were not present under the section 987 regulations proposed in 1991 (the "1991 Proposed Regulations").[5] Many taxpayers have followed the 1991 Proposed Regulations for computing gains and losses under section 987 in lieu of the

[5] INTL-965-86, 56 F.R. 48457 (Sep. 25, 1991).

regulations proposed under section 987 in 2006 (the "2006 Proposed Regulations").[6] Thus, many taxpayers are faced with changing the approach to complying with section 987 that they followed for a quarter century – and 30 years after the passage of the Tax Reform Act of 1986 (TRA of 1986),[7] which enacted section 987. We discuss these issues further below.

b. Change in the approach for computing taxable income

Taxpayers historically computed the taxable income of a non-functional currency section 987 QBU by taking the QBU's functional currency trial balance and making appropriate tax adjustments to conform the balance to U.S. federal income tax principles in the QBU's functional currency. After computing taxable income in the QBU's functional currency, taxpayers then translated the income to the tax owner's functional currency using the average exchange rate for the year. Under this approach, all assets and liabilities maintained their functional currency basis and each item was converted using the same exchange rate.

The Final Regulations dramatically shift how taxable income is computed for non-functional currency QBUs. The Final Regulations require taxpayers to analyze each individual asset and liability to determine whether it is an "historic" or "marked" item.[8] Historic items are converted to the tax owner's functional currency based on the average exchange rate in the year the item came into existence, which may be difficult to determine.

Moreover, the Final Regulations may require a tax adjustment to be computed as a marked item in one section 987 QBU and an historic item in another section 987 QBU. Each item is aged at the account level in each QBU. For example, suppose QBU A has a prepaid item that when aged on a first-in first-out basis is determined to originate within 2016. QBU B has a prepaid item

[6] REG-208270-86, 71 F.R. 52876 (Sep. 6, 2006).

[7] P.L. 99-514.

[8] These terms are defined in Treasury regulation sections 1.987-1(d) and (e).

that has a balance that is comprised of items from 2016, 2015 and 2014. When computing QBU B's taxable income, the taxpayer would need to compute part of the adjustment at the 2014, 2015 and 2016 yearly-average historic exchange rates. Therefore, when preparing tax adjustment workbooks, the system must accept multiple exchange rates (current year and prior year) for the same adjustment, significantly complicating the process. Key factors in the determination of a marked versus historic item are the life of the item and its currency denomination, which leads to differing approaches for similar items. For example, long-term deferred revenue and prepaid accounts are historic, whereas the same items which are short-term are marked. Amounts in the QBU's functional currency are marked but those in a non-functional currency are historic.

This key difference – between the 1991 Proposed Regulations' approach to section 987 QBUs that required a single exchange rate and the approach of the Final Regulations that may require multiple exchange rates – will force taxpayers to modify nearly all of their tax return work papers to accommodate adjustments at different exchange rates. These changes will require taxpayers to spend considerable amounts of time and resources complying with the regulations.

c. New Tax Adjustments

The Final Regulations may also require tax adjustments that did not arise under the 1991 Proposed Regulations. For example, assume that B is a Country X disregarded entity with the FC as its functional currency and is wholly owned by U.S. corporation P. B has an intangible asset it is amortizing for both book and tax purposes over the same period under the 1991 Proposed Regulations. When computing taxable income under the 1991 Proposed Regulations, no book to tax adjustments were required. Under the Final Regulations, however, this asset would be an historic item requiring computation of its tax amortization at an historic exchange rate. This change in methodology creates a new book-tax difference that did not exist under the historic approach taken under the 1991 Proposed Regulations. As above, taxpayers will be required to change their work papers, systems, and processes to comply with the approach in the Final Regulations, resulting in additional significant compliance costs.

d. Section 988 Transactions of QBUs

Most taxpayers' accounting systems automatically compute realized and unrealized exchange gains and losses in a manner that is largely consistent with U.S. federal income tax principles. Under the 1991 Proposed Regulations, when a section 987 QBU had a regarded section 988 transaction, the currency gain or loss was computed based on the fluctuation between the QBU's currency and the non-functional currency. Under the Final Regulations, if a section 987 QBU has a transaction in the functional currency of its tax owner then there should be no foreign currency gain or loss because the gain or loss is treated as an item of its tax owner. With this new approach, taxpayers will need to either update their existing accounting systems or devise manual workarounds. Even more challenging, under the Final Regulations when a section 987 QBU has a transaction in non-functional currency other than the currency of its tax owner, the currency gain or loss is valued by computing the exchange rate movement between the tax owner's functional currency and the non-functional currency balance. This is a substantially different approach than under U.S. GAAP and will be a tremendous burden on taxpayers, who will need to create or modify systems to handle a voluminous number of currency translation transactions separate and apart from that recorded on taxpayers' GAAP books and records. Many taxpayers will be required to hire additional resources or outsource this work to third parties at a significant cost because the internal systems work will not be completed in time to comply with the new rules when they are effective for many taxpayers on January 1, 2018. In some cases manual workarounds may prove impossible and taxpayers may face non-compliance risk until the appropriate systems can be modified or built.

e. Transaction aging

Although in many cases marked items may be short-term and historic items may be long-term, that is not always the case. When effective, the Final Regulations require each taxpayer to determine the appropriate exchange rate to convert an asset or liability from the functional currency of the section 987 QBU to the currency of the tax owner. This requires a taxpayer to determine the year in which an asset or liability was created. While determining the age of long term assets or liabilities for which there are existing book tax basis differences (fixed assets, some intangibles, and long term loans) should be achievable through normal tax and accounting records, determining the age of assets or liabilities is nevertheless a challenge. That is, some taxpayers may have kept the necessary historical tax and accounting records to accomplish this task, but it may require manual searches of archived information, which increases the risk of inaccuracy. Other taxpayers may not have maintained the necessary records at all or their records may be incomplete. Moreover, given that the unrecognized section 987 gain or loss must be computed on a tax basis, a taxpayer must age its book balances as well as its tax adjustments. Without a tax basis balance sheet this is extremely difficult for taxpayers to accomplish with the necessary degree of accuracy.

Another issue facing taxpayers is what to do with assets or liabilities that would normally be considered a short term item, but when aged are deemed to be long term. If these accounts also have tax adjustments, this creates further complexity for taxpayers adopting the Final Regulations. This complexity requires taxpayers to adjust their tax return work papers and processes to allow for different exchange rates. Further, it may be that an item has tranches in several years requiring a taxpayer to make several different tax adjustments for the same item and account. This complexity creates additional risk and adds significant time to both the provision and tax return processes. As an example, assume QBU A has accrued contingencies on its balance sheet as of January 1, 2018, composed of balances from 2014, 2015 and 2016. Assume further that there is a book to tax adjustment for accrued contingencies. To properly compute taxable income, QBU A must be able to determine which part of the adjustment needs to be converted at the 2014, 2015 and 2016 yearly average rate, which again is a much more involved and time consuming process than the approach taken under the 1991 Proposed Regulations.

f. The "Simplified Method" is not simplified

Under the annual deemed termination election (ADTE), a taxpayer's section 987 QBUs terminate on the last day of each taxable year. By making the election, taxpayers are also allowed to make a second election to translate all items included in a QBU's taxable income into the tax owner's functional currency at the average rate for the year. As discussed in the Preamble to the Final Regulations, the intent of these rules is to simplify the Regulations' recordkeeping requirements. However, despite the attempt at simplification, the mechanics of the ADTE require a taxpayer to maintain the same records they would need if they followed the regular method under the Final Regulations.

Under the ADTE, a taxpayer's section 987 QBUs terminate at the end of each year and all of the assets become part of a deemed remittance to the tax owner. The deemed remittance is converted from the functional currency of the QBU into the owner's functional currency at the spot rate at year end. Immediately after the remittance, the same assets and liabilities are deemed to transfer back to the section 987 QBU. Under Treasury regulation section 1.987-8T(d), the section 987 adjusted basis in the assets received from the owner's deemed contribution will be translated from the owner's functional currency to the section 987 QBU's functional currency using the spot rate on the date of transfer for marked items and the yearly average rate for historical items.

The translation of historical items at the yearly average rates presents additional complexities. In almost every circumstance, the yearly average exchange rate for one year would be different than the previous year's average rate. This difference would create a change in the functional currency basis of a QBU's historic items, requiring taxpayers to update the functional currency cost recovery schedules every quarter of every year. Further, to complete tax provision computations and estimated payment computations, a taxpayer would need to make assumptions about the functional currency basis in its assets without knowing what the actual basis in its historic assets are until the end of the year. That is, a taxpayer would not know the average exchange rate for the year when completing its tax provision and estimated tax payment computations in, for example, the third quarter of that year as the year has not yet ended.

To solve these issues, taxpayers will be required to track historical items in the same way they would need to if they fully adopted the Final Regulations, and then back into the functional currency amount at the end of the year when the average yearly exchange rate is known. The fact that taxpayers need to track historical basis provides very little administrative benefit since they still need to do most of the work required if they had fully adopted the Final Regulations.

2. Authority to Adopt the Approaches in the Final and Temporary Regulations

a. Overview

A significant feature of the TRA of 1986 was the addition of a comprehensive set of rules governing matters associated with carrying out business enterprises overseas using a currency other than the U.S. dollar. These rules are embodied in subpart J[9] of the Code, and featured the

[9] Sections 985-989.

adoption of the functional currency concept derived from Generally Accepted Accounting Principles (FAS 52).[10] As described in the Joint Committee's 1986 Blue Book, the intent of Congress was to "distinguish between foreign business operations that are eligible to determine income or loss in a foreign currency (before translation in U.S. dollars) and other foreign operations . . . ."[11]

However, subpart J, and particularly section 987(3)(B), does not explicitly provide rules for determining exchange gains and losses associated with transfers of property or remittances from one QBU to another. Instead, for exchange gains and losses to be realized a remittance or distribution from the QBU to its owner would have to occur and such QBU would have to keep its books and records in a currency other than the dollar (the functional currency). Regulations under section 987 were to be drafted in light of the guidance in the legislative history of subpart J, pursuant to a legislative grant to issue regulations. As noted, the Final and Temporary Regulations were published under the authority granted by Section 989(c)[12] on December 8, 2016.

The Final and Temporary Regulations represent the culmination of several attempts by the IRS and Treasury to issue guidance in this area. The process commenced over thirty years ago and resulted in the two sets of proposed regulations noted above. The Service withdrew the 1991 Proposed Regulations, notwithstanding their paucity (a mere seven pages), over concerns that the regulations "may not have fully achieved their original goal of providing rules that are administrable."[13] The Service was also concerned that these rules could lead to the "recognition

[10] Prior to the enactment of subpart J, taxpayers relied on sparse guidance consisting of several rulings issued by the IRS and on some scattered court precedents. H. Report No. 99-426, 99th Cong. 1st Sess. 449 (1985). *See also* the discussion of pre-1986 law in the Preamble to the 2006 Proposed Regulations.

[11] TRA of 1986, Blue Book at page 1089.

[12] "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subpart . . . ." Section 989(c).

[13] Notice 2000-20, 2000-1 C.B. 851.

of foreign currency gains and losses under [in]appropriate circumstances."[14] A background concern seemed to be that the method set forth in the 1991 Proposed Regulations could induce taxpayers to transfer nonfinancial assets solely to trigger an advantageous foreign currency tax loss. The Final Regulations, in contrast, were derived primarily from the 2006 Proposed Regulations, with some significant modifications. As discussed above, it is unclear whether the goal of providing administrable rules has been achieved in the Final Regulations. We discuss below whether the IRS and Treasury department have authority for their attempt to combat the perceived ability to inappropriately recognize losses under section 987 by dictating to taxpayers the timing of such losses and in some cases eliminating the ability to recognize economic foreign currency losses without a corresponding adjustment under section 481.

b. Executive Order 12866 guidelines for drafting administrable and cost effective regulations

When promulgating proposed or final regulations the Service in the past has routinely stated in preambles to such pronouncements that its exercise in rulemaking was exclusively and preclusively governed by specific provisions in the Code or the general authority to promulgate regulations in section 7805. Accordingly, the Service takes the position that the Administrative Procedure Act's (APA) notice and comment provisions do not apply to most of its rulemaking, although the IRS generally provides the opportunity for stakeholders to comment on its regulations. Similarly, the Service routinely assumes, as it did in the 2006 Proposed Regulations, that the exercise of its regulatory authority is exempt from Executive Order 12866 (1993) (the "E.O.") because, in its view, its regulations do not generally involve a "significant regulatory action" within the meaning of the E.O. Under the E.O., a significant regulatory action is one that

[14] *Id.*

has, among other things, "an annual effect on the economy of $100 million or more or adversely affect[s] in a material way the economy, a sector of the economy, [or] productivity . . . ."[15]

The IRS has taken this position because, in its view, any significant effect on the economy flows from the underlying statute and not the regulation (*i.e.*, the regulations are interpretative and not legislative). Nevertheless, the guiding principles set forth in the E.O. provide an instructive benchmark from which to measure the administrability and reasonableness of any regulation, even if the IRS is correct that the E.O. does not generally apply to its rulemaking. When Congress grants an agency legislative regulatory authority, it intends the agency (*i.e.*, the Service) to promulgate sensible, cost effective and administrable regulations. Section 989(c) reflects this intent, directing the Service to issue regulations that are "necessary or appropriate" under subpart J. Administrable regulations are of particular importance in the tax area because, unlike regulations issued by other agencies, taxpayers are statutorily barred from using the federal courts to enjoin the application of Treasury Regulations prior to their effectiveness and application to a particular taxpayer, even if the regulations are demonstrably burdensome or on their face appear to exceed the authority granted by Congress to promulgate them.[16] This fact alone, aside from Section 989(c), should have given the Service reason for restraint when exercising its broad regulatory authority. The Final Regulations are in many cases not administrable and therefore do not keep with Congressional intent.

[15] E.O. 12866, *available at* https://www.reginfo.gov/public/jsp/Utilities/EO_12866.pdf.

[16] Section 7421(a). Once a taxpayer expends resources and complies with the regulations as written, there is little incentive left for such taxpayer to challenge tax regulations post-compliance given the risks and uncertainties associated with such an endeavor. The added costs to engage in a protracted litigation and the high bar that must be overcome for a successful challenge pre- and post-application of the regulations pose a formidable barrier for taxpayers. Furthermore, not complying with the regulations is simply not an option. This is the reason why any exercise in regulatory authority by the Service must be measured under strict standards because taxpayers have very few real opportunities to check regulatory overreach.

We believe it is instructive to compare the Final Regulations, and the authority in Section 989 to promulgate regulations, with the guidelines issued in the E.O. setting forth standards for all agencies for appropriate and necessary rulemaking. Section 1(a) of the EO states that "agencies should assess all costs and benefits of available regulatory alternatives." Further, an agency "shall design its regulations in the most cost-effective manner to achieve the regulatory objective,"[17] and then "only upon a reasoned determination that the benefits of the intended regulation justify its costs."[18] Regulations should be "tailor[ed] . . . to impose the least burden on . . . businesses and -other entities"[19] and such regulations shall be drafted "to be simple and easy to understand, with the goal of minimizing the potential for uncertainty and litigation."[20]

The regulations under section 987 ballooned from approximately seven pages in the 1991 Proposed Regulations to 220 pages under the Final Regulations, which does not include the additional burden and challenges of the Temporary Regulations. The complexity of these regulations is primarily a function of the modified net worth method used to determine exchange gains and losses under section 987, some of the complexities with which are discussed above. We do not believe that the complexity in implementing the Final and Temporary Regulations was intended by Congress, nor do the regulations satisfy the sensible guidelines for rulemaking in the E.O. Further, the timing chosen to issue the Final Regulations seemingly disregards the additional compliance burdens imposed on publicly traded taxpayers with significant operations overseas. The Final Regulations were published on December 8, 2016, barely three weeks before 2016 year end close for calendar year publicly traded companies and 30 years after subpart J was first enacted in the TRA of 1986. The financial accounting rules require publicly listed companies to fully

[17] E.O. Section 1(5).

[18] E.O. Section 1(6).

[19] E.O. Section 1(11).

[20] E.O. Section 1(12).

account for the impact of such regulations in the fourth quarter of 2016, despite the regulations' January 1, 2018, effective date. This required an enormous and costly, not to mention frantic, effort by many companies with significant overseas operations to assess the impact of the regulations on their financial statements to ensure accurate reporting.

Even with all their complexity and detail, the Final Regulations left many areas unclear (or to be subject to future rulemaking, such as in the partnership area) and implemented rules with seemingly little statutory support that are burdensome and complex to implement without a significant expenditure of resources. The difficulties imposed by the requirement to track the purchase date of historical depreciable and amortizable assets, to track the different historical exchange rates for the myriad components of cost comprising inventory, and the resulting need to invest in and program accounting software and personnel training, should have been given more study and consideration by the IRS TEI therefore urges the IRS to ease the compliance burden by adopting the recommendations set forth at the end of this document that address some of these concerns.

c. Elimination of the "Deferral Transition Method" in the Final Regulations

Perhaps the most significant change from the 2006 Proposed Regulations was the elimination in the Final Regulations of the "deferral transition method" and the adoption of the requirement that all taxpayers subject to the Final Regulations transition to a new approach through the Fresh Start Method. Under the deferral transition method, gain or loss realized upon the required deemed termination of all QBUs on the last day of the tax year preceding the transition date of the Regulations would be deferred and allowed "to be recognized under the remittance rules of Section 1.987-5 for periods after the transition date."

Under the Fresh Start Method, all QBUs are deemed liquidated and the assets distributed to the owner of the QBU. Any resulting realized but unrecognized exchange gain or loss on previously settled or collected monetary assets and liabilities – that is, those assets and liabilities that do not appear on the balance sheet of the QBU at the time of transition – arising from the use of a prior accounting method (*e.g.*, from the use of the approach in the 1991 Proposed Regulations) would be lost. The vast majority of these gains and losses are true economic gains and losses and thus not the type the Service is generally concerned with taxpayers exploiting via non-economic transactions. The assets distributed under the Fresh Start Method are then deemed to be recontributed to a newly reconstituted QBU that uses the same functional currency that it had used before the deemed distribution. Any hope of preserving any unrealized currency gain or loss after the effective date in those recontributed assets is a function of the choice of exchange rate assigned by the Final Regulations to each monetary asset. Non-monetary assets, such as depreciable equipment and amortizable intangibles, are assigned an historical exchange rate by the Final Regulations via reference to the year the asset was acquired. (Nevertheless, these assets are not intended to give rise to any prospective exchange gain or losses under the Final Regulations.) Naturally, this requires searching archives and the tracking purchase records – no easy task. For monetary assets such as cash, receivables and payables, (*e.g.*, a "marked item") the Final Regulations also direct the use of a historical rate.[21] If locating this information in the company's records is possible, then in theory the unrealized currency gain or loss inherent in some assets or liabilities would be preserved as long as such receivables and payables have not yet been collected or settled prior to the effective date of the Final Regulations. In contrast, cash balances associated with already collected receivables or settled payables (with realized but yet *unrecognized* exchange gain and losses) are treated as carrying a new historical exchange rate unrelated to those carried

[21] The Final Regulations allow for resorting to "reasonable assumptions consistently applied" in arriving at these historical rates if records are lacking, but provide little guidance in this regard.

by the realized and settled monetary assets that gave rise to the cash balances. This decoupling of cash from the exchange rate history associated with the settled liabilities and collected receivables that gave rise to that cash all but assures that taxpayers will lose those unrecognized but realized exchange losses upon adoption of the Final Regulations. For many multinationals, the expiration without recognition of such exchange losses may be a material item on their financial statements. In the event that the collection or settlement of receivables and payables occurs after the effective date of the Final Regulations, the resulting currency gain and loss would be measured by the change of the historical exchange rate of the functional currency with regard to the reporting U.S. dollar.

There does not appear to be any statutory support for selecting a transition method that has the effect of eliminating without adjustment taxpayers' gains and losses. At most, Section 989(c)(2) speaks of "limiting," but conspicuously *not* eliminating, the recognition of currency losses on "certain remittances." The sparse authority and no legislative history to support the Service's approach does not, in TEI's view, sanction a wholesale permanent denial of losses to taxpayers resulting from the Service mandating deemed liquidations of QBUs under the Fresh Start Method.

The "deferral transition method" previously provided for was consistent with, and provided for what would ordinarily be expected by taxpayers when conforming to, a mandated change in accounting method under section 481(a) principles. Taxpayers subject to the 2006 Proposed Regulations could elect such treatment unless they had failed to make any section 987 determinations or used an "unreasonable method." The Preamble to the 2006 Proposed Regulations also stated that following the 1991 Proposed Regulations or an "earnings only" section

987 method would be considered “a reasonable method” under the transition rules of the 2006 Proposed Regulations.

The elimination of the “deferral transition method” in the Final Regulations will impact measurably and substantially a significant number of U.S. multinationals which had accounted for exchange gain and loss of their foreign QBUs using a reasonable accounting method. This is because U.S. GAAP requires companies with disregarded entities, partnerships, or branches overseas to recognize currently the effects on future taxable income of currency gains or losses resulting from as yet unremitted earnings accounted for in a currency (*i.e.*, a functional currency) other than the U.S. dollar. This results from the assumption required by U.S. GAAP that earnings from such branches will be remitted in the future.

The elimination of the “deferral transition method” without an equivalent transition mechanism in the Final Regulations has forced companies to reverse their deferred tax liabilities (in essence, a “write-off”) or net deferred tax assets associated with unrealized currency gain and losses. This may result in “bunching” of losses on financial statements in a single fiscal year (*i.e.*, losses that may have been recognized over a number of years are instead recognized in a single year). Furthermore, under ASC 740 (the accounting rule governing taxes for financial accounting purposes) the resulting impact on a company’s financial statements must be recognized in the quarter in which the new Regulations were enacted (*i.e.*, the fourth quarter of 2016, which caused public companies to attempt to fully digest, account for, and report the impact of the Final and Temporary Regulations in the last three weeks of 2016).

In light of the above, the Final Regulations force taxpayer to choose between two potentially adverse outcomes. First, implementing the Final Regulations but making no remittances until the effective date of the Regulations. This means taxpayers would undergo a true economic loss and associated decrease in earnings by, in effect, forfeiting unrealized currency losses without the corresponding benefit of a tax deduction. Alternatively, taxpayers could remit cash to trigger an exchange loss in 2017 prior to the effective date of the Final Regulations, which would recognize the unrecognized currency losses by claiming a corporate tax deduction in the United States (assuming the remittance is not subject to Temporary Regulations' anti-abuse rule).

Because the dollar has strengthened in relation to most other foreign currencies recently, the Final Regulations may have inadvertently provided multinationals with a strong inducement to accelerate, *en masse*, deductions for such currency losses. This sudden move to trigger remittances and claim deductions could adversely impact U.S. tax collection efforts in 2017. This may require U.S. companies with overseas operations being accounted for in a functional currency other than the dollar to leverage their foreign branches (and non-U.S. disregarded entities) to obtain the cash necessary to finance such remittances in 2017. Consequently, the Final Regulations' unintended and immediate effect is to skew, on purely tax grounds, the business decision making process of multinationals of how to raise, deploy, and remit cash from their overseas operations. The consequent overleveraging may leave such operations at a competitive disadvantage *vis a vis* foreign owned competitors and make future borrowings more expensive.

TEI recommends that to prevent the elimination of economic losses, the regulations be amended to allow for utilization of historic economic losses and gains. After these are recognized, then the "new" policy of disallowing section 987 gain or loss on non-financial assets can be implemented as part of a "fresh start." This would be a more balanced approach and fairer to taxpayers with unrecognized losses.

d. The Final Regulations' override of section 481

The elimination in the Final Regulations of the "deferral transition method" raises a more fundamental question: what authority under subpart J (or anywhere else in the Code) permits the

IRS to deprive taxpayers of an adjustment when mandating a change of accounting method? Any such authority would need to permit the IRS to override section 481's mandated preservation of adjustments in the event of a change in accounting method. We have been unable to locate any administrative precedent or legislative source sanctioning such extraordinary exercise of regulatory discretion asserted by the Service. Furthermore, the legislative history of the TRA of 1986, and in particular subpart J of the Code, does not grant the IRS such sweeping authority to enact such rules under subpart J.

In the Preamble to the Final Regulations the Service states that the Fresh Start Method "together with the requirement under § 1.987-10(d) to adjust unrecognized section 987 gain or loss to prevent double counting, have a similar effect as allowing a section 481 adjustment with respect to section 987 gain or loss arising from assets and liabilities reflected on a section 987 QBU's transition date balance sheet." While the preamble speaks of an adjustment with "similar effect" as a section 481 adjustment, Treasury regulation section 1.987-10(d) relief is limited to adjustments of net unrecognized section 987 gain or loss to the extent income, gain, deduction or loss arising from exchange gain or loss is being taken into account more than once. The occurrence of this scenario is improbable given that the Final Regulations require the Fresh Start Method and the choice of the historical rate for all assets (and liabilities). Although not explicitly stated, this requirement causes gain or loss to be omitted from income inclusion, which conflicts with the mandate of section 481.[22] Accordingly Treasury regulation section 1.987-10(d) may deprive certain taxpayers of a portion of future exchange gain or loss resulting from these accounting adjustments when transitioning, under the Fresh Start Method, to the Final Regulations. This result does not appear to be supported by the Code or its legislative history. In particular, foreign

[22] Section 481(a)(2) mandates that all "adjustments . . . determined to be necessary solely by reason of the change [in accounting method] in order to prevent amounts from being duplicated or omitted . . . ."

currency gains and losses from assets and liabilities that have been collected and settled – and would therefore not be reflected on the balance sheet at the time the Fresh Start Method applies and yet are tracked for financial statement purposes in a cumulative translation adjustment (CTA) or similar account – are lost because they have been realized but not recognized for U.S. tax purposes.[23]

In general, section 446(e) and Treasury regulation section 1.446-1(e) requires taxpayers to secure the consent of the Commissioner before changing a method of accounting. The Service has always asserted, and the courts have understood, that the Commissioner possesses "considerable discretion to prescribe conditions to the granting of consent" to an accounting change, including changing from one permissible method to another, and changing from an impermissible method to a permitted method.[24] The purpose is to provide the Commissioner with the authority to ensure that a taxpayer employ accounting methods that clearly reflect income. Nevertheless, the Commissioner's discretion in this area, while broad, is not unlimited.[25] The Commissioner has no discretion to determine a different method of accounting when Congress selects the method or the legislative history points to a specific method.

Treasury regulation section 1.446-1(e)(ii) authorizes the Commissioner to establish "administrative procedures" for setting forth the terms and conditions to allow a taxpayer to obtain the Commissioner's consent to a change in accounting method. Concurrent with the enactment of section 446(e), Congress added section 481 which requires that all "adjustments . . . determined necessary solely by reason of the change" in accounting method "*shall be taken* into account" "in

[23] The Preamble to the Final Regulations recognizes the issue with gains and losses from previously settled items, noting "it is unclear how a section 481(a) adjustment could apply with respect to section 987 gain or loss arising from assets and liabilities that are no longer on the balance sheet on the transition date, absent a requirement to redetermine section 987 gain or loss as if the final regulations had applied from the inception of the QBU."

[24] *Ross v Commr*. 169 F.2d 483, 489 (1st Cir. 1948).

[25] *National Bank of Fort Benning v Comm*. 79-2 USTC 9627 (DC Ga.).

order to prevent amounts from being duplicated *or omitted*."[26] This directive that all accounting adjustments must somehow be taken into account to avoid duplications or omissions of income and expenses applies notwithstanding that an accounting method change may be mandated by law, initiated by the Commissioner upon audit, or the result of a change initiated by the taxpayer. This sensible rule prevents the Service from depriving a taxpayer of the benefit of any such adjustments and requires the Commissioner to uphold the rule that accounting methods must clearly reflect income. However, the Commissioner retains considerable discretion in determining the number of tax years or "spread" to be granted for positive or negative adjustments resulting from an accounting method change, unless Congress mandates otherwise.

Section 481 applies to all changes in "methods of accounting" and the Service has broadly applied such a term and the authority derived from it under section 481. The discretion granted to the Service is necessary to avoid a taxpayer from introducing significant distortions in reporting income and expenses in the year of change of the accounting method. However, section 481 does not grant the Commissioner any discretion or authority to dispense with or ignore altogether any adjustments that would result from an accounting method change mandated by law. This rule applies even if the adjustments originated from a change from an improper accounting method to a permitted method.

The Service has defined the term "method of accounting" to include the overall accounting treatment for income and expenses and of any material item if such treatment is not specifically prescribed elsewhere.[27] Further, a change in the method of accounting "includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any

[26] Section 481(a)(2) (emphasis added).

[27] Treas. Reg. § 1.446-1(a)(1).

material item used in such overall plan."[28] The Regulations go on to state that a "material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction."[29]

The Service has correctly described an organized and recurring means employed by a taxpayer to track and quantify unrealized currency gains and losses (and ultimately determine when and how much of these are realized) as a "method." This was the case notwithstanding that such a method could be deemed an unreasonable method. For example, in Section J. of the Preamble to the 2006 Proposed Regulations the Service described the 1991 Proposed Regulations as establishing a method. Similarly in such Preamble the Service referred to the fresh start method as a method. The Service also referred to the "earnings only" section 987 method as a method.[30]

Methods that track unrealized currency gains and losses and determine when and how much of these are realized and reported in the United States clearly involve "the proper time for the inclusion of an item in income or the taking of a deduction." Further, such an item would clearly be a "material item" or otherwise the focus on and the purpose for enacting of subpart J for this item would make little sense. Accordingly such item is material and the methods meet the definition of a method of accounting under Section 446(e).[31]

Under pre-TRA 1986 law a leading treatise writer opined on this very matter concluding as set forth below that such methods were accounting methods under section 446:

> The choice between the U.S. dollar and a foreign currency as the value standard [i.e. functional currency] and, if a foreign currency is chosen, *the subsequent choice between the profit and loss and the net worth methods* are exactly parallel to the examples of accounting methods given in the

[28] Treas. Reg. § 1.446-1(e)(2)(ii)(a).

[29] *Id.*

[30] In fact Schedule C-1, line 4 of Form 8858 (Information Return of U.S. Persons with Respect to Foreign Disregarded Entities) includes the following question: whether the tax owner "changed its method of accounting for section 987 gain or loss with respect to remittances from a foreign disregarded entity during the year."

[31] *See id.*

> Regulations: these choices will affect the timing of any gain or loss from changes in the exchange rate with respect to capital.[32]

Subpart J of the Code further supports this view. The "separate transactions method" is explicitly named as a method of accounting in section 985(b)(3). Moreover, the Code also treats any change in functional currency "as a change in a taxpayer's method of accounting for purposes of Section 481."[33] Surprisingly, the Final Regulations do not treat tax elections (and revocations) related to currency as changes in accounting methods, which does not appear to be supported by the law. Indeed, the 2006 Proposed Regulations took the position that any "elections made under Section 987 shall be treated as methods of accounting . . . and are governed by the general rules concerning changes in methods of accounting." (*i.e.*, section 481.) The Final Regulations reversed this view and now state that "An election under section 987 is not governed by the general rules concerning changes in methods of accounting."[34] Nevertheless, elections cannot be revoked without the Commissioner's consent.[35] In sum, there is no support in the Code for *not* treating elections (or revocations) under subpart J as changes in accounting methods.

Finally, Section 989(c)(1) directs the Secretary of the Treasury to prescribe regulations to transition taxpayers from "the net worth method of accounting" if the taxpayer employed such accounting method before the enactment of subpart J of the Code. Nevertheless, the Final Regulations through the Fresh Start Method, transition taxpayers to a net worth method to determine exchange gains and losses.

[32] Donald R. Ravenscroft, *Taxation and Foreign Currency*, Cambridge (1973), at 178 (emphasis added).

[33] Section 985(b)(4).

[34] Treas. Reg. § 1.987-1(g)(4).

[35] Treas. Reg. § 1.987-1(g)(5).

The Blue Book clearly explains that this directive to the Secretary was necessarily aimed solely to "prevent a mismatching or double inclusions or deductions of exchange gain and loss."[36] This wording tracks very closely the purpose and means set forth in section 481 when there is a change in method of accounting. In other words, any Regulations issued associated with transitioning a taxpayer from this method (or any other method) *required* avoiding double inclusions or deductions in the year of change. Section 989(c)(1) did not authorize the Service to prescribe regulations to deprive taxpayers of claiming some or all deductions for currency losses that do not reference or follow section 481 principles. In fact, as noted section 989(c)(1) directs the Secretary to promulgate procedures to be followed by taxpayers using a net worth method before the enactment of subpart J. Congress made its intentions clear in Committee Reports that the Service was to move from the net worth method (and any of its formulations) to the profit and loss method. The Blue Book similarly confirms this as does the Preamble to the 2006 Regulations.

Despite clear authority that a change in the method for tracking foreign currency gains and losses of QBUs is a change in accounting method under section 481 and that subpart J was intended to move taxpayers off of the net worth method, the Final Regulations require all taxpayers to adopt a modified version of the "net worth method" and deprive taxpayers of the adjustments they are entitled to under section 481. The Preamble to the Final Regulations does away with the argument that taxpayers are entitled to proper adjustments under section 481 by stating the Final Regulations' approach "in effect" allows adjustments similar to section 481(a) and that a full section 481(a) adjustment "would operate as a one-time election to reduce Federal income tax liability." We believe that this reasoning is plainly insufficient to overcome the overwhelming authority set forth above that the change mandated by the Final Regulations is a change in

[36] *General Explanation of the Tax Reform Act of 1986*, "Blue Book", Prepared by the Staff of the Joint Committee on Taxation, at page 1113.

accounting method entitling taxpayers to relief under the rules of section 481. Moreover, we have not found any support in the case law, regulations or the law supporting the proposition that the Service by regulation can override section 481 when the IRS requires taxpayers to change their method of accounting.

e. Lack of support for the adoption of the Net Worth Method

As discussed above, section 989(c)(1) supports the view that Congress intended the Service to dispense with the net worth method and adopt instead the profit and loss method for determining exchange gain and losses. The purpose has been aptly explained as follows:

> A profit and loss method can be viewed as being more consistent with the functional currency concept than a net worth method. Under a profit and loss method, the functional currency is used as the measure of income or loss, so that earnings determined for U.S. tax purposes bear a close relationship to taxable income computed by the foreign jurisdiction. Further, a profit and loss method minimizes the accounting procedures that otherwise would be required to make item-by-item translations under a net worth method.[37]

Prior to the adoption of the 1986 Code, the Service and some case law sanctioned the use of the net worth method and the income and loss method. What the Service accomplished in the 2006 Proposed Regulations and adopted in the Final Regulations was a modified version of the net worth method for computing exchange gain and losses, while using the income and loss method for the annual translation of earnings of QBUs. The Service defended this approach in the Preamble of the 2006 Proposed Regulations as consistent with Congressional intent, or at least not in contradiction to it.

Under this net worth approach, the Service requires taxpayers to identify and classify monetary type assets and liabilities ("marked items") and distinguish them from "historical" assets which are translated at the date when the Final Regulations take effect at their historical acquisition

[37] Robert A Katcher, *Section 987 Proposed Regulations: Net Worth with a Twist*, 36 International Journal, No. 4, 159 (April 2007).

rate. The former assets are the ones that the Service singles out as having the potential to vary in value in relation to the dollar which is the reporting currency of U.S. taxpayers. These concepts are not consistent with a functional currency concept and income and loss approach, and rely on looking at the dollar as the reference measure. This is not surprising since this was the result of borrowing directly from section 988(c). This approach is neither referenced nor explicitly sanctioned by section 987 (or section 988) or the legislative history of section 987.[38]

Section 988 is geared to a different approach and purpose. It is meant to track certain specified transactions engaged by a QBU in a currency other than its functional currency and to measure the resulting currency gain or loss. The Service further borrows methods and concepts from the Dollar Approximate Separate Transactions Method,[39] which again is not supported or sanctioned by a fair reading of the legislative history or section 987. The end product adopted by the Final Regulations is an unwieldy eight step process which requires complicated tracking and record keeping software and significant training and knowledge on how the Final Regulations work both for examiners and tax preparers. A "Simplified Method" is introduced for tracking currency gains and losses resulting from the sale of inventory which is neither simple nor administrable, as discussed above.

f. The CFC Termination Rule and treating section 987 gains as subpart F income is not supported by subpart J and the legislative history

Another item in the Final Regulations that does not seem to be supported by the statute or the legislative history is the required termination of a QBU if its owner ceases to be a controlled

[38] The Preamble to the Final Regulations explained that the reason for the choice of this approach was to maintain "consistency with Section 988, modified to take into account administrability and policy considerations unique to Section 987."

[39] Treas. Reg. § 1.985-3.

foreign corporation (CFC). We have not discerned from subpart J generally, or sections 987 and 989 in particular, any authority for the CFC termination rule.

Similarly, we do not find any statutory support for classifying section 987 gains as foreign personal holding company income ("FPHCI," a type of subpart F income) thus depriving a taxpayer of the tax deferral (until an actual dividend or remittance) associated with business income generated by such U.S. owned foreign company. Section 954(c)(1)(D) directs that only net currency gains arising from transactions governed by section 988 would be FPHCI. Furthermore, there is no reference in section 954 to section 987 or currency gains and losses derived therefrom in the legislative history. Further, this history does not suggest the conflation of section 988 and 987 for subpart J purposes.

g. Partnerships: lack of statutory support to adopt the aggregate approach and to create separate rules for a newly defined separate types of partnerships

For purposes of applying section 987 to partnerships, the key initial issue is whether the regulations under section 987 should apply to partnerships on an aggregate or an entity basis. In the 2006 Proposed Regulations, Treasury and the IRS adopted the aggregate approach for all partnerships. However, in the Final Regulations, Treasury and the IRS limited the aggregate approach to partnerships wholly-owned by related persons (*i.e.*, Section 987 Aggregate Partnerships). In contrast, Treasury and the IRS concluded that non-aggregate partnerships will be subject to a completely different regulatory regime under section 987 that will be determined at some point in the future. There does not appear to be any basis to treat wholly-owned partnerships differently from partnerships with at least one unrelated partner.

As an initial matter, the adoption of the aggregate approach in the Final Regulations creates a situation that is overly complex, difficult to administer from a compliance perspective and inconsistent with the basic principles of subchapter K of the Code treating a partnership as an entity separate from its owners.[40] In contrast, the adoption of an entity approach for all partnerships under section 987 would have created a more reasonable and administrable alternative that was also internally consistent with subchapter K and the intent and letter of Section 989(a). The latter clearly defines a QBU as a separate and clearly identified unit of a trade of business which maintains separate books and records. Nearly contemporaneous with the enactment of subpart J, the Service issued regulations in 1990 under Section 989(a) defining a partnership as a QBU.[41] The Final Regulations now do not seem supported by Section 989(a).

Moreover, the creation of two different regulatory systems for wholly-owned and non-aggregate partnerships seems to make the situation even more complex and unreasonable to administer and comply with (for example, a partnership 100% owned by related parties and one 99% owned by related parties would be subject to two dramatically different sets of rules).

Finally, Treasury and the IRS made this difficult situation even worse by providing no subchapter K coordination rules in the Final Regulations. In fact, the Service withdrew the existing coordination guidance originally issued with the 2006 Proposed Regulations without any discussion or explanation of the reasoning behind such action. As a result, Treasury and the IRS have created an overly and unnecessarily complex compliance environment for partnerships under section 987 while providing taxpayers with no guidance on how to actually apply the inconsistent aggregate approach rules of section 987 within the entity based rules of subchapter K.

h. The Method Adopted In the Final Regulations for Sourcing Exchange Gains or Losses are not supported by Statute or the legislative history of subpart J

Section 987(3)(B) requires sourcing of exchange gain and loss "by reference to the source of the income giving rise to post-1986 accumulated earnings." Notwithstanding this clear

[40] Sections 701 *et seq*.

[41] Treas. Reg. § 1.989(a)-1(b)(2). T.D. 8279 (January 3, 1990).

directive, the Final Regulations adopted an asset method under Treasury regulation section 1.861-9T used for sourcing interest expense. The Preamble to the Regulations explained that this method constituted a "reasonable proxy for post-1986 accumulated earnings in the context of section 987." The Preamble of the Final Regulations further states that the Treasury and the IRS declined to determine the source of exchange gain and loss "with direct reference to post-1986 earnings" as directed by the Code, to avoid "substantial complexity and compliance burdens." Needless to say, a proxy of post-1986 earnings is not by reference to the source of the income giving rise to post-1986 earnings and therefore inconsistent with the statutory mandate.

3. Recommendations

The Final and Temporary Regulations, as discussed above, implement a complex approach to the recognition of foreign currency gains and losses with respect to QBUs. Compliance with these regulations will be extremely difficult for many taxpayers and it will be a substantial burden on the IRS to properly administer them. Further, the Regulations, with dubious authority, eliminate in many cases a taxpayer's ability to recognize a true economic loss for tax purposes (losses that may be material) via a change in accounting method without adjustments, and as such are inconsistent with section 481. Moreover, the so-called "simplified" method that taxpayers may elect to comply with these regulations is in fact not any simpler than the regular method. For these reasons, TEI recommends:

1. In the interest of good tax administration, the IRS withdraw the Final and Temporary Regulations and reissue them as newly proposed regulations with an appropriate comment period. In this regard:

   a. The prior version of regulations under section 987 were a decade old when the Final and Temporary Regulations were promulgated in December 2016, which was 25 years after the Service first issued proposed regulations under that section in 1991. Thus, for over three decades taxpayers were left without a set of final, comprehensive guidance under section 987 after its enactment in the TRA of 1986. In the interim, taxpayers were permitted to adopt any reasonable method to comply with section 987, only to have up to 30 years of experience with that method upended upon the issuance of the Final and Temporary Regulations. Moreover, it is poor tax administration to finalize, with major substantive changes, proposed regulations that had been outstanding for a decade without providing taxpayers a further chance to comment on such changes. Withdrawing the Final and Temporary Regulations and reissuing them as proposed regulations would permit taxpayers to formally weigh in on the approach in those regulations through the formal notice and comment procedures of the APA. This is particularly crucial with respect to the substantial changes made in the Final and Temporary Regulations from the 2006 Proposed Regulations, such as the elimination of the deferral transition method and subchapter K coordination rules. Taxpayers could then recommend changes or alternatives to the regulations to ease the compliance and administrative burden. Reissuing the regulations as proposed regulations would also give taxpayers the flexibility to continue to follow their historic approach while planning for the changes portended by the Final and Temporary Regulations.

b. We note that the Final and Temporary Regulations permit taxpayers to make certain elections. Thus, if the IRS re-proposes these regulations, the Service should give taxpayers the option to make these elections under such re-proposed regulations in a similar manner in which taxpayers were permitted to early-adopt the 2006 Proposed Regulations by filing a change of accounting method with the Service.[42]

c. The re-proposed regulations should have an effective date at least two years after such regulations are finalized.

2. Should the government choose not to withdraw and re-propose the Final and Temporary Regulations, TEI recommends that the Service:

   a. Delay the effective date of the Final and Temporary Regulations by one year to January 1, 2019, to give taxpayers additional time to modify their systems and ease compliance with the new rules; and

   b. To avoid the unnecessary elimination of accrued economic gains and losses, either (i) permit taxpayers to recognize all inherent economic gain/loss in their QBUs and then adopt a clean approach going forward; (ii) permit taxpayers to adopt the deferral transition method of the 2006 Proposed Regulations; or (iii) provide that the Final Regulations constitute a change in accounting method under section 481 that entitles taxpayers to corresponding adjustments in accordance with that section.

Conclusion

Tax Executives Institute appreciates the opportunity to offer its views on REG-128276-12, and the Final and Temporary Regulations, regarding foreign currency gain and loss for section 987

[42] *See* Prop. Treas. Reg. § 1.987-1(f) (2006).

QBUs. Please do not hesitate to contact Benjamin R. Shreck, TEI Tax Counsel, at 202.464.8353 or bshreck@tei.org, should you have any additional questions.

Respectfully submitted,

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