



What's News in Tax

Analysis that matters from Washington National Tax

Section 987 Regulations—Accounting for Income Taxes Considerations of Issuance of the Regulations

January 31, 2017

by Katie LeBlanc, Joyce Liu, and Ashby Corum, Washington National Tax*

Section 987 regulations¹ issued on December 7, 2016, can significantly change how a company measures taxable income of a foreign branch with a functional currency different from its owner. The regulations generally are not effective until 2018 for calendar year taxpayers; however, the issuance of the regulations should be viewed as a change in tax law with the effect recognized for financial reporting purposes on December 7, 2016. Companies should assess and recognize the potential impact of the regulations in financial statements for the reporting period that includes the December 7, 2016 issuance date.

Background

Section 987 was enacted as part of the Tax Reform Act of 1986 to provide guidance on determining taxable income when a qualified business unit (“QBU”)² owned by a taxpayer has a functional currency different from that of the taxpayer. In general, under section 987 an owner of a QBU must include in its taxable income the QBU’s annual taxable income or loss, as well as foreign currency exchange gain or

* Katie LeBlanc and Joyce Liu are senior managers in, and Ashby Corum is the partner-in-charge of the Accounting for Income Taxes group in Washington National Tax (“WNT”).

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

² In general, a QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. An eligible QBU does not include a QBU that is subject to the Dollar Approximate Separate Transactions Method rules of section 1.985-3.

loss with respect to the QBU. The statute provides limited guidance on the operational aspects of the calculations needed to comply with section 987.

1991 and 2006 Proposed Regulations

Section 987 regulations proposed in 1991 provide that the net income of a QBU is determined annually by translating the QBU's net taxable income or loss using the yearly average exchange rate for the tax year. In addition, under the 1991 proposed regulations, section 987 gain or loss is recognized upon a remittance from the QBU in reference to an equity pool and a basis pool. The 1991 proposed regulations were withdrawn and new section 987 regulations were proposed in 2006. Many companies have used the methodology in the 1991 proposed regulations as a reasonable means of complying with section 987 in the absence of final regulations.

2016 Final and Temporary Regulations

On December 7, 2016, the IRS issued final and temporary regulations (the "Regulations") that provide guidance under section 987.³

❖ Annual QBU Income or Loss

Under the Regulations, a QBU maintains an income statement in its functional currency under U.S. tax principles, and then converts each item of income, gain, deduction, and loss on the statement to the QBU owner's functional currency pursuant to the exchange rate conventions provided in the Regulations. As a general rule, items of the income statement are translated at the average exchange rate for the year. However, depreciation and amortization deductions (and other cost recovery deductions) as well as the basis of historic assets (that are not cost of goods sold) are translated at their historic exchange rates (defined as the average rate for the year the relevant asset was acquired or placed in service). In addition, the Regulations provide a complex convention for translating cost of goods sold, which generally translates cost of goods sold at the yearly average exchange rate and adjusts for inventoriable costs attributable to historic assets (e.g., depreciation) to account for the difference in the exchange rate from the current year and the year in which the asset from which the inventoriable cost was derived was acquired or placed in service. Taxpayers can make certain elections that affect the translation of the income statement items, including an election to translate all income statement items at the yearly average exchange rate.

³ The Regulations generally do not apply to trusts, estates, S corporations, and partnerships (other than section 987 aggregate partnerships). Further, the Regulations generally do not apply to banks, insurance companies, leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts (collectively, "specified entities"), other than specified entities that engage in transactions primarily with related persons that are not themselves specified entities. Any entity not subject to the Regulations must use a reasonable method to comply with section 987, and cannot rely on the Regulations. Section 987 generally does not apply to a QBU that has a USD functional currency. Unless an election is made otherwise, when a USD QBU is owned by a CFC (as defined below), section 988 applies with respect to items on the books and records of the QBU that would give rise to section 988 gain or loss if the items were acquired, accrued or entered into directly by the CFC owner of the QBU. In this case, the CFC treats the items of the QBU as properly reflected on the books and records of the CFC. Alternatively, an election can be made to apply section 987 to the USD QBU in lieu of applying section 988 to the CFC.

Translating certain items at historic rates represents a major change from the 1991 proposed regulations, and has the practical effect of denominating the tax basis attributable to the relevant historic assets in the owner's functional currency, rather than the QBU's functional currency. Taxpayers will need to maintain data on the average exchange rates for the years they acquired (or placed in service) the historic assets in order to determine the proper translation of depreciation, depletion, and amortization, as well as gain or loss on historic assets.

❖ Section 987 Gain or Loss

For purposes of determining section 987 gain or loss, the Regulations set forth an 8-step methodology to track on an annual basis the QBU's unrecognized section 987 gain or loss, which is based on the QBU's balance sheet. These steps isolate the currency movements attributable to marked items. In general, a QBU is required to maintain a balance sheet in its functional currency, which then is translated at year-end to the owner's functional currency. The Regulations set forth default translation rates and provide elections for using alternative exchange rates for certain assets and liabilities. Under the default rules, marked assets and liabilities⁴ are translated at the spot rate on the last day of the year, while historic assets and liabilities⁵ are translated based on their historic rates (that is, the exchange rate that was in effect in the year that the asset was acquired or placed in service, or the liability was incurred).

The section 987 gain or loss recognized annually by a taxpayer is equal to the "net unrecognized section 987 gain or loss" multiplied by the "remittance proportion." The remittance proportion is the remittance for the year divided by the sum of the aggregate adjusted basis of the gross assets at the end of the year and the remittance for the year.

Effective Date and Transition Rules

The Regulations are generally effective for tax years beginning on or after one year after the first day of the first tax year following December 7, 2016 (the "Transition Date"), which would be January 1, 2018, for a calendar year taxpayer. Taxpayers can elect to apply the Regulations for tax years beginning on or after December 7, 2016, provided the rules are consistently applied to all the taxpayer's QBUs.

Taxpayers generally must transition to the rules in the Regulations using the "fresh start" transition method, which treats each QBU as terminating on the day before the Transition Date, and transferring all its assets and liabilities to a new QBU on the Transition Date. No section 987 gain or loss is recognized as a result of the deemed termination. Accordingly, any unrecognized section 987 gain or loss calculated under the taxpayer's previous section 987 method is eliminated upon adoption of the Regulations. For purposes of determining the unrecognized section 987 gain or loss in the first year that the Regulations apply ("fresh start year"), all assets and liabilities, without regard to whether an asset or

⁴ A marked item is an asset (marked asset) or liability (marked liability), and generally includes debt instruments, payables and receivables, forward, futures, and option contracts, and prepaid expenses.

⁵ A historic asset is an asset that is not a marked asset.

liability is a marked item or a historic item, that are deemed transferred to the new QBU are translated at their historic rates on the Transition Date, based on the average exchange rate during the year in which the asset was acquired (or placed in service), or liability incurred. Subsequent to the Transition Date, marked items are translated at the yearly average exchange rate, while historic items generally are translated at their historic rates.

Notwithstanding the generally delayed effective date of January 1, 2018, certain rules in the Regulations are effective immediately, including rules that substantially restrict the recognition of losses in connection with certain QBU terminations, certain transactions involving partnerships, and certain related party outbound transactions. Any section 987 loss deferred under these rules generally is recognized when the QBU makes subsequent remittances, or when the QBU ceases to be owned by a member of the controlled group. The amount of any section 987 loss deferred as a result of a transaction that occurs prior to the fresh start year is adjusted on the Transition Date to reflect the new methodology for calculating section 987 gain or loss set forth in the Regulations.

❖ Elections

Several elections are available under the Regulations. Most notably, a taxpayer may make an election (on a QBU-by-QBU basis) to translate all QBU income statement items at the yearly average exchange rate, but only if the taxpayer also makes an annual deemed termination election to annually recognize section 987 gain or loss for all QBUs (as well as all QBUs owned by persons related to the owner). Other available elections include a grouping election to treat all section 987 QBUs of a taxpayer with the same functional currency as a single section 987 QBU, an election to use a spot rate convention, an election to use spot rates in lieu of yearly average exchange rates, and an election to use the historic inventory method.

Accounting for Income Taxes Considerations

ASC 740 requires the calculation of income taxes to be based on enacted tax laws. Some new regulations interpret or clarify current law, while other regulations change currently enacted tax law. Accordingly, we expect companies to view the issuance of the Regulations as a change in an enacted law and account for the change in the period that includes the December 7, 2016 issuance date. The amount of the adjustment will be based on temporary differences as of December 7, 2016.⁶ The effect of a change in tax law is recognized as a discrete event and the related income tax expense or benefit is allocated entirely to continuing operations during the interim period that includes the issuance date, even if the adjustments to deferred tax assets or liabilities previously recorded were attributable to cumulative translation adjustments in other comprehensive income or items in other areas of the financial statements.

⁶ See ASC 740-10-25-48.

Guidance on accounting for income taxes notes that some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting.⁷ Accordingly, in addition to recording the appropriate local and U.S. current taxes related to a foreign branch's results and local and U.S. deferred taxes related to a foreign branch's assets and liabilities, a U.S. owner will also generally have a U.S. temporary difference associated with the amount of unrecognized section 987 gain or loss of the branch.

A deferred tax liability is not recognized for a taxable outside basis difference for a parent entity's investment in a foreign subsidiary if the indefinite reversal criterion is met.⁸ Additionally, a deferred tax asset is recognized for a deductible outside basis difference for an investment in a foreign subsidiary only if the temporary difference is apparent to reverse in the foreseeable future.⁹ These exceptions (together, the "ASC 740-30 exceptions") generally are not relevant to basis differences associated with a foreign branch because the income of the foreign entity is included in the parent entity's taxable income without regard to remittances. However, an unrecognized section 987 gain or loss that is only taxable or deductible upon a remittance from a foreign branch to its owner is essentially part of the taxation of an investment in a foreign entity.¹⁰ Accordingly, a company may have an accounting policy to subject an unrecognized section 987 gain or loss to the ASC 740-30 exceptions regardless of whether the foreign operations are legally a branch or a foreign disregarded entity.¹¹

For companies with a section 987 QBU owned by a U.S. entity that previously was using the methodology provided under the 1991 proposed regulations and that are not expecting to make any elections when they adopt the Regulations, common areas in which deferred tax assets or liabilities may need to be adjusted as a result of issuance of the Regulations include the net unrecognized section 987 gain or loss under the previous methodology that the company employed, the net unrecognized section 987 gain or loss under the Regulations for marked items, and temporary differences under the Regulations for historic assets.

Net Unrecognized Section 987 Gain or Loss under the Previous Method

QBUs will be deemed to terminate on the day before the Transition Date. Unrecognized section 987 gains and losses under a taxpayer's previous methodology are eliminated at such time as part of the transition to the Regulations. Deferred taxes are generally recognized based on the tax laws and rates expected to apply when temporary differences reverse.¹² Accordingly, no deferred tax asset or liability

⁷ See ASC 740-10-25-24.

⁸ ASC 740-30-25-17 and 25-18(a).

⁹ ASC 740-30-25-9.

¹⁰ See the ASC Master Glossary definition of a Foreign Entity that includes a branch as a foreign entity.

¹¹ We acknowledge diversity in practice may exist and that some believe an unrecognized section 987 gain or loss is not subject to the ASC 740-30 exceptions.

¹² See ASC 740-10-30-8.

will be recognized for the portion of an unrecognized section 987 gain or loss that is expected to be eliminated. Companies will need to assess how much, if any, of their existing unrecognized section 987 gain or loss is expected to become taxable or deductible before the adoption of the Regulations, and adjust the related deferred taxes to reflect this expectation. The adjustment would be made as an adjustment to the deferred tax asset or liability, and not as an adjustment to a valuation allowance or other offsetting account.

Specifically, a company should recalculate the deferred tax assets and liabilities based on the amount of the unrecognized section 987 gain or loss that will be recognized prior to the fresh start year. The recalculated amounts should be based on expected remittances that will be made prior to the fresh start year (taking into account the loss deferral rules in the Regulations) and subject to a company's accounting policies for applying the ASC 740-30 exceptions discussed above. Thus, taxpayers should continue to use their existing methodology to calculate unrecognized section 987 gain or loss as of December 7, 2016, taking into account the new rules in the Regulations with respect to certain terminations and partnership transactions, and based only on expected remittances prior to the Transition Date. An owner that previously did not recognize a deferred tax asset (since it wasn't apparent to reverse in the foreseeable future) or a deferred tax liability (since it met the indefinite reversal criteria) may need to recognize a deferred tax asset or liability if the company now has plans for the QBU to make a remittance.

We believe adjustments to deferred tax assets or liabilities for unrecognized section 987 gains and losses that are not expected to become deductible or taxable prior to the fresh start year, and for changes in the ability to meet the ASC 740-30 exceptions should be made in the period that includes December 7, 2016, with the related income tax expense or benefit allocated entirely to continuing operations.

Marked Items under the Regulations

Under the Regulations, on the Transition Date, the tax basis of marked items will be translated at a historic rate. However, any gain or loss generated when the marked assets and liabilities denominated in the QBU's functional currency are recovered or settled after adopting the Regulations will not be recognized at the time of recovery or settlement. Instead, the impact of the differences between the tax basis of marked assets and liabilities at historic exchange rates and the exchange rate at the end of the fresh start year will be taken into account in determining the unrecognized section 987 gain or loss for the QBU in the fresh start year. Deferred taxes should be recognized for this new temporary difference, subject to a company's accounting policies for applying the ASC 740-30 exceptions, in the reporting period that includes December 7, 2016. The related income tax expense or benefit is allocated entirely to continuing operations. Deferred taxes should only be computed for items that are expected to remain on the QBU's balance sheet on the Transition Date; accordingly, deferred taxes may not be needed as of December 7, 2016 for certain current assets or liabilities if an entity expects to adopt the Regulations in 2018. The temporary difference determined as of December 7, 2016 would be based on the differences between the historic rates and the exchange rate as of December 7, 2016. The section 987

gain or loss in the fresh start year will take into account the change in value of the QBU's marked items based on the differences between their historic rates and the ending exchange rate of the fresh start year, and will form a new unrecognized section 987 gain or loss.

Historic Assets under the Regulations

Under the Regulations, the tax basis of historic assets are translated at historic rates. As such, historic assets that are expected to remain on the balance sheet at the Transition Date will have a new tax basis as a result of the issuance of the Regulations. For an amortizable asset expected to be fully used by a QBU, the new tax basis should be measured as the amount of future amortization deductions at the historic exchange rate expected to be allowed after adoption of the Regulations plus the amount of future amortization deductions at a current exchange rate for periods prior to the fresh start year. Accordingly, the deferred taxes for historic assets of a QBU may need to be remeasured as a result of the revised methodology to calculate tax basis. Additionally, because this would represent deferred taxes for specific assets that would reverse through the operations of the QBU, and not an amount that is only taxable upon a remittance from the QBU, we do not believe the ASC 740-30 exception will apply. The adjustments to deferred taxes will also be recognized in the reporting period that includes December 7, 2016 with the related income tax expense or benefit allocated entirely to continuing operations.

The above discussion emphasized section 987 QBUs owned directly by a U.S. taxpayer. The Regulations will have similar implications for determining the earnings and profits of controlled foreign corporations ("CFC") with section 987 QBUs. Although the Regulations may not affect the actual earnings and profits computation made by a CFC until it adopts the Regulations, companies with investments in CFCs that have recognized outside deferred tax assets and liabilities for the CFCs with section 987 QBUs should also consider the impact of the Regulations on the measurement of those outside basis deferred taxes upon issuance of the Regulations.

As the Regulations are expected to add complexity and administrative burdens in calculating section 987 amounts, companies should have systems and controls in place to calculate unrecognized section 987 gain or loss, temporary differences on historic assets, and the associated deferred tax assets and liabilities. For companies that currently have or are expected to have significant current or deferred tax consequences related to section 987, consideration should be given to enhancing disclosures by providing a description of the issuance of the Regulations and its anticipated effect on the financial statements.

Example

USCO, a U.S. Corporation, wholly owns UK, a foreign entity which is treated as a disregarded entity for U.S. federal income tax purposes. USCO is a calendar year taxpayer. UK is a QBU for section 987 purposes and conducts a foreign trade or business in pounds with a Pound functional currency for both U.S. GAAP and U.S. federal income tax purposes. USCO complies with section 987 based on the method set forth in the 1991 proposed regulations. USCO has an accounting policy to apply the ASC 740-30 exceptions to any unrecognized section 987 gain or loss. The first year that the Regulations

apply to USCO is the tax year that begins January 1, 2018. USCO does not expect to make any section 987 elections. USCO's tax rate is 40 percent and local income taxes of UK are ignored for simplicity.

UK was established on January 1, 2015 with a £4 million capital contribution. On that same day, UK borrowed £6 million from an unrelated party. UK used the funds to acquire its sole asset, a depreciable asset that was acquired on January 1, 2015, for £10 million with a 20-year U.S. GAAP life and a 10-year U.S. federal tax life. The straight line method is used for both book and tax purpose. Operations are breakeven before considering the effects of depreciation and any taxable loss generated can be recovered by offsetting with other USCO income. USCO has a long history of earnings that are expected to continue into the future. Accordingly, assume no valuation allowance would be needed on any deferred tax assets. UK expects to own the depreciable asset and have the loan outstanding in 2018. Assume the exchange rate was GBP 1: USD 1.7 when the asset was acquired and throughout 2015, that the rate averaged GBP 1: USD 1.4 for 2015 and 2016, and the exchange rate was GBP 1: USD 1.2 on December 7, 2016.

USCO has an unrecognized section 987 loss of \$1.6 million at December 7, 2016. Although USCO may make remittances from UK from time to time, prior to the issuance of the Regulations there were no planned remittances that were apparent to occur in the foreseeable future. Accordingly, USCO did not recognize a deferred tax asset on the unrecognized section 987 loss. As a result of the issuance of the Regulations, USCO now intends to make a remittance from UK prior to adopting the Regulations on January 1, 2018, that will result in a deduction for half of the unrecognized section 987 loss. The other half of the unrecognized section 987 loss is never expected to be recognized under the Regulations. As a result of the intent to make a remittance, half of the unrecognized section 987 loss meets the criteria for recognition under ASC 740-30-25-9 and USCO recognizes a deferred tax asset of \$320,000 ($\$800,000 \times 40$ percent) with a corresponding deferred tax benefit.

Additionally, USCO will need to remeasure its deferred taxes for the depreciable asset as it will now have a different tax basis as a result of the issuance of the Regulations. The U.S. GAAP financial statement carrying amount of the asset was £9 million on December 7, 2016, and the U.S. tax basis of the asset under the 1991 proposed regulations was £8 million on that date. Accordingly, as of December 7, 2016, under the 1991 proposed regulations, there is a taxable temporary difference of £1 million ($\text{£}8 \text{ million} - \text{£}9 \text{ million}$) for which a deferred tax liability of \$480,000 ($\text{£}1 \text{ million} \times 40 \text{ percent} \times 1.2$) is recognized. Tax depreciation deductions of £1 million will be allowed in 2017 under the 1991 proposed regulations and \$11.9 million from 2018 through the end of the life of the asset under the Regulations ($\text{£}10 \text{ million} \times 1.7$ is \$17 million of initial basis, with seven of its ten-year life remaining; $\text{£}10 \text{ million} \times 7 / 10$). This results in total tax basis of \$13.1 million ($\text{£}1 \text{ million} \times 1.2 + \11.9 million). Accordingly, there is a deductible temporary difference of \$2.3 million ($\text{£}13.1 \text{ million} - (\text{£}9 \text{ million} \times 1.2)$) for which a deferred tax asset of \$920,000 ($\text{£}2.3 \text{ million} \times 40 \text{ percent}$) should be recognized as of December 7, 2016. As a result, a deferred tax benefit of \$1.4 million is recognized for remeasuring the deferred taxes for the depreciable asset from a \$480,000 deferred tax liability to a \$920,000 deferred tax asset.

Finally, upon adoption of the Regulations, USCO should consider the need for deferred taxes for the new unrecognized section 987 gain or loss related to the loan, a marked liability. At the Transition Date to the Regulations, the tax basis in the loan will be based on its historic rate and will be \$10.2 million (£6 million * 1.7). The loan has a current financial statement carrying amount of \$7.2 million (£6 million * 1.2). Accordingly, USCO would expect to create an unrecognized section 987 gain of \$3 million (\$10.2 million - \$7.2 million) during the fresh start year under the Regulations, based on current exchange rates. As USCO may make remittances from UK from time to time, it does not meet the indefinite reversal criterion and would recognize a deferred tax liability and corresponding deferred tax expense of \$1.2 million (\$3 million x 40 percent) for the unrecognized section 987 gain upon issuance of the Regulations.

In summary, USCO would recognize a \$320,000 deferred tax benefit for its existing unrecognized section 987 loss, a \$1.4 million deferred tax benefit for remeasuring its deferred taxes for the depreciable asset and a \$1.2 million deferred tax expense for the unrecognized section 987 gain related to the loan. The net \$520,000 deferred tax benefit would be recognized in continuing operations in the period that includes December 7, 2016.

Conclusion

The Regulations are complex and can be a significant departure from how companies have previously determined the impact of currency movement on the taxable income of a foreign branch that has a functional currency different from its owner's as well as section 987 gain or loss on the branch. The effect of a change in tax law should be recognized in financial statements in the period that includes the enactment date. Companies should assess and record the potential impact of the issuance of the Regulations within the reporting period that includes December 7, 2016, and have systems and controls in place to detect or prevent an error in the financial statements.

□ □ □ □

The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP.