Navigating Final Rules on Foreign Currency Translation Gains and Losses

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On December 11, 2024, Treasury and the IRS published a new set of final section 987 regulations (the "2024 Final Regulations") for determining the taxable income or loss, and foreign currency gain or loss, of a taxpayer with a section 987 "qualified business unit" (QBU) that has a functional currency different from its owner. These rules will generally apply to US taxpayers and controlled foreign corporations (CFCs) that have a branch (or own a disregarded entity) that operates in a foreign country, such as a Mexican disregarded entity that is owned by a US taxpayer. The section 987 rules generally result in a QBU owner recognizing ordinary gain or loss and, where the QBU owner is a CFC, can affect its U.S. shareholders' global intangible low-taxed income (GILTI) inclusions.

The 2024 Final Regulations reflect the government's decades-long efforts to provide comprehensive foreign currency rules that are administrable, result in appropriate gain or loss recognition, and minimize the potential for abuse. Compared with prior versions of regulations, the new rules simplify the computations. Nevertheless, navigating the operating and transition rules will likely impose substantial compliance burdens for many taxpayers and could affect when taxpayers recognize losses. In this alert, we highlight critical aspects and implications of the 2024 Final Regulations, which require immediate attention as discussed below.

EFFECTIVE DATES WARRANT PROMPT ASSESSMENT

Before delving into specific aspects of the 2024 Final Regulations, it is important to note that the rules generally apply to taxable years beginning after December 31, 2024 (i.e., calendar year 2025 and later). Taxpayers may elect to apply those rules to taxable years beginning before that date and ending after November 9, 2023 (calendar year 2023 and 2024), if they and certain related parties also consistently apply them in their entirety and on their original timely filed returns (including extensions) for the first taxable year to which the taxpayer chooses to apply the regulations. Similarly, taxpayers may elect to apply prior versions (the final 2016 and 2019 section 987 regulations) to certain tax periods subject to similar requirements.

The 2024 Final Regulations generally apply to QBU terminations that occur after November 9, 2023, and to check-the-box elections to change the status of a QBU that are made after that date (even if the election is effective before November 9, 2023).

A&M Insight: We understand that the 2024 Final Regulations may represent a change in law from a GAAP perspective. This is significant because although the 2024 Final Regulations apply to taxable years beginning after December 31, 2024, the rules went into effect on December 10, 2024. This means that taxpayers may need to adjust any deferred tax assets or liabilities associated with pretransition gains or losses in the fourth quarter of 2024.

BASIC FRAMEWORK RETAINED

Section 987(3) requires taxpayers to make proper adjustments (as prescribed by the IRS) for transfers of property between QBUs of

the taxpayer that have different functional currencies. These adjustments include recognizing foreign currency gain or loss upon a remittance.

With a few notable exceptions, the 2024 Final Regulations retain much of the basic framework of the proposed regulations published in 2023 (the "2023 Proposed Regulations"). Key aspects include the following:

- Use of the "foreign exchange exposure pool" (FEEP) method for determining foreign currency translation gains and losses based on applicable exchange rates [1]
- An "annual recognition election" to recognize the entire net unrecognized section 987 gain or loss annually
- A "current rate election," under which all balance sheet items of the QBU are translated at the year-end spot rate
- Temporarily suspending certain foreign currency translation losses and recognizing those suspended losses only to the extent of the section 987 gain
- Determining and recognizing foreign currency pretransition gain or loss (see "Transition Rules" section below)
- Maintaining detailed books and records related to items attributed to the QBU in the functional currency of the QBU and its owner, the adjusted balance sheet of the QBU, and the exchange rates

A&M Insight: With the various options available, taxpayers should model the effects of the elections and combinations (e.g., making both the annual recognition and current rate elections or making just one, or neither of them) and assess the tradeoffs, such as simplification versus potential tax consequences. For example, taxpayers that make a current rate election may use a simplified formula and approach for determining "QBU net value" in lieu of having to prepare tax basis balance sheets. However, taxpayers making a current rate election but not an annual recognition election would be subject to the loss suspension rule. Careful analysis of the implementation options is critical as once an election is made, it generally may not be revoked within five years without IRS consent.

PURPORTED SIMPLIFICATIONS

Treasury and the IRS have modified certain rules in the 2024 Final Regulations in an attempt to reduce complexity in determining foreign currency gain or loss. For example:

- The ability to use certain elements of the earnings and capital method for determining unrecognized section 987 gain or loss if a current rate election is made
- A new lookback rule that allows suspended losses to be recognized in the year of remittance to the extent of section 987 gain recognized in the current year and the three preceding taxable years
- Using the functional currency of the QBU (rather than the owner) for certain non-functional currency transactions, which is generally consistent with the approach used for financial statement purposes
- Providing de minimis rules, such as (1) not suspending losses if the section 987 loss is below a specified threshold and (2) treating small QBUs as not having a pretransition gain or loss

A&M Insight: Many taxpayers (and their advisors) will welcome these simplifications, but nevertheless, face the daunting task of navigating and applying the 2024 Final Regulations. For branches and disregarded entities that are likely to have material foreign currency translation adjustments (due to currency fluctuations or otherwise), modeling the rules and alternatives will be important. Additionally, taxpayers should consider the effects of other, potentially significant changes in US federal tax law that could occur in 2025.

LIMITED APPLICABILITY TO PASSTHROUGH ENTITIES

Only certain portions of the 2024 Final Regulations apply to partnerships and S corporations, with other portions reserved. Because the 2024 Final Regulations do not fully explain how to apply section 987 to a partnership, a partnership and an S corporation (and their owners) must use a reasonable approach for implementing section 987 that is consistent with the tax code. The 2024 Final Regulations provide examples of potential reasonable approaches.

In addition, the 2024 Final Regulations do not apply to trusts and estates as Treasury and the IRS continue to study what rules are appropriate to such entities and their beneficiaries.

The 2024 Final Regulations do apply to CFCs in which a US shareholder owns stock (directly or indirectly by attribution). The foreign

currency gain or loss recognized by a CFC will generally affect the amount of any GILTI inclusion with respect to the CFC. Treasury and the IRS continue to study whether the 2024 Final Regulations or a simplified approach should apply to CFCs or to partnerships with only foreign partners.

A&M Insight: Foreign partnerships that do not have any US activities are not generally required to file a US tax return. US taxpayers that invest in such partnerships generally receive US tax information from the partnership as a contractual matter. Such partners should determine the information they will want foreign partnerships to provide to them for computing section 987 gain or loss.

TRANSITION RULES: PRIOR METHODS AND ELECTIONS MATTER

For QBUs existing before the first day of the first taxable year to which the 2024 Final Regulations apply, taxpayers must compute pretransition foreign currency translation gain or loss, which is carried forward and taken into account along with current year translation gains and losses under the FEEP method. The computation differs based on whether an eligible pretransition method was applied. For taxpayers that did not apply an eligible pretransition method (which could include taxpayers that have used the GAAP approach, as well as those that did not apply any method), the 2024 Final Regulations are generally more burdensome, requiring annual computations for all taxable years beginning after September 7, 2006, and ending before the transition date.

The pretransition gain or loss is treated as a net unrecognized section 987 gain or loss if the taxpayer has a current rate election in effect (but not an annual recognition election). Otherwise, the pretransition loss is treated as a suspended section 987 loss upon transition. However, taxpayers may elect to recognize the pretransition gain or loss for each QBU ratably over a 10-year period.

A&M Insight: For branches and disregarded entities in which an eligible pretransition method was not applied in the past, the taxpayer will need financial statements for the branch or entity going back to 2007. This could be daunting under normal circumstances, and even more so if the branch or disregarded entity was acquired as part of an acquisition of its owner, in which case the records may not even be available.

DISREGARDED TRANSACTIONS (PROPOSED REGULATIONS)

Along with the 2024 Final Regulations, Treasury and IRS issued proposed regulations dealing with disregarded transactions between a QBU and its owner. These proposed regulations would allow taxpayers to elect to translate a group of frequently recurring disregarded transactions between a QBU and its owner by using the average exchange rate for the year, rather than the spot rate for the date of each transaction.

A&M Insight: Compared to the 2024 Final Regulations, the approach in the proposed regulations for disregarded transactions is simpler to apply and can reduce the administrative burden and cost of maintaining records with respect to each transaction. Fortunately, taxpayers can choose to rely on the proposed regulations so long as they and certain related parties also rely on them in their entirety. However, prior to doing so, taxpayers should analyze the implications of the proposed regulations in their entirety.

A&M TAX SAYS

We have entered a new era for computing foreign currency translation gains and losses with the arrival of the 2024 Final Regulations. While the simplifications noted above will be helpful, the immediate implementation challenges and compliance burdens for taxpayers could be significant. Due to potential implications for financial statement purposes, taxpayers may need to quickly navigate the menu of options (including modeling and analysis), determine pretransition gain or loss (for as many as 18 pretransition years), and prepare for ongoing compliance.

Although the regulatory environment remains uncertain under the imminent change in administration, taxpayers should plan accordingly to comply with the 2024 Final Regulations while staying abreast of new developments. For example, under the Congressional Review Act, the 2025 Republican Congress could effectively, and relatively quickly, invalidate administrative rules finalized in the latter part of 2024. In addition, more taxpayers may be willing to challenge various regulations under *Loper Bright Enterprises v. Raimondo* [2] or other theories.

Stay tuned as A&M Tax will be closely monitoring the developments associated with these and other regulations. In addition, our tax advisors are available to assist you with navigating the complex foreign currency rules, assessing implementation options, and developing strategies to help ensure compliance.

[1]. For a more complete discussion of the 2023 Proposed Regulations (including an explanation of the FEEP method), see Kevin M. Jacobs et al., "*Newly Proposed Section 987 Regulations: Balancing Perfection with Practicality*," Alvarez & Marsal, Tax Alert, November 21, 2023, https://www.alvarezandmarsal.com/insights/newly-proposed-section-987-regulations-balancing-perfection-practicality

[2]. See Kevin M. Jacobs et al., "*Supreme Court Overturns Chevron: Navigating the New Landscape for Tax Regulations and Judicial Review*," Alvarez & Marsal, Tax Alert, July 2, 2024, https://www.alvarezandmarsal.com/insights/supreme-court-overturns-chevron-navigating-new-landscape-tax-regulations-and-judicial

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This alert includes a snapshot of some predominant business and individual tax proposals based on the candidates' released statements, as well as the current Administration's FY 2025 Budget for Harris and Trump's previous positions, including TCJA provisions.

House Passes Tax Relief Bill, Contemplates Path for SALT Deduction Cap

On January 31, 2024, the U.S. House of Representatives overwhelmingly passed The Tax Relief for American Families and Workers Act of 2024 (H.R. 7024) by a vote of 357 to 70, concluding yearslong negotiations over the expansion of the child tax credit and the relief from a trio of business tax provisions enacted by the TCJA (the capitalization of research or experimental (R&E) expenses, the business interest deduction limit, and the phase-out of 100% bonus depreciation for certain property).

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