

Code Sec. 987—Back to the Future

By Brian Jenn

To paraphrase Mark Twain, the history of Code Sec. 987 may not repeat itself, but it certainly is starting to rhyme. Enacted as part of the Tax Reform Act of 1986, the statutory language of Code Sec. 987—merely a long sentence—could hardly be more obscure. This vagueness may be a principal reason that the project of promulgating regulations under Code Sec. 987 is about to enter its fourth decade without any real closure for taxpayers or the government. To the celebration of many taxpayers, that project is now returning to its origins with the issuance on February 25, 2026 of Notice 2026-17 (the “Notice”), which allows taxpayers to follow an approach to Code Sec. 987 that includes key elements of proposed regulations issued in 1991 (the “1991 Proposed Regulations”). In particular, the income of a Code Sec. 987 qualified business unit (QBU) generally could be translated at the yearly average exchange rate, and Code Sec. 987 gain or loss would be computed on the basis of equity and basis pools. Nonetheless, other elements of the final Code Sec. 987 regulations issued in 2024 would remain in effect, including the scope of a Code Sec. 987 QBU, the remittance and termination concepts, and loss suspension and gain and loss deferral rules.

Taxpayers generally would be permitted to rely on the rules in the Notice with respect to the computation of Code Sec. 987 gain and loss and the translation of Code Sec. 987 income and loss for taxable years ending before new proposed regulations are published. Additionally, the Notice indicates that the Internal Revenue Service (IRS) and Treasury intend to issue proposed regulations that would permit taxpayers to elect not to apply Code Sec. 987(3) at the controlled foreign corporation (CFC) level, such that Code Sec. 987 gain or loss would no longer be recognized or calculated at the CFC level. Taxpayers may not yet rely on the CFC election.

After a quick overview of the history of Code Sec. 987 regulations, this column describes the Notice provisions regarding the equity and basis pool method, the rules in the existing final regulations that would continue to apply, and the new CFC election.



BRIAN JENN is a Partner in the Washington, DC office of McDermott Will & Schulte LLP.

A Brief History of Code Sec. 987 Regulations

The 1991 Proposed Regulations, the government's first regulatory adventure under Code Sec. 987, offered a relatively simple model for calculating Code Sec. 987 gain or loss and translating Code Sec. 987 income or loss that in some ways echoes similar calculations undertaken for financial accounting purposes. Code Sec. 987 gain or loss was calculated based on an equity pool maintained in the Code Sec. 987 QBU's functional currency and a basis pool maintained in the owner's functional currency. The equity pool was increased by contributions to the QBU and income and reduced by remittances from the QBU and losses, all accounted for in the QBU's functional currency. The basis pool was similarly adjusted to account for contributions, remittances, income, and loss, but the adjustments were made in the owner's functional currency. Gain or loss generally was recognized when the QBU made a remittance to its owner (determined on a daily basis) by determining the portion of the equity pool that was remitted, translated at the yearly average exchange rate into the owner's functional currency, and subtracting the portion of the basis pool that was remitted. Code Sec. 987 income or loss was determined in the QBU's functional currency but translated into the owner's functional currency at the yearly average exchange rate. All described in fewer than 4000 words (including preamble) across about a dozen pages.

Although taxpayers were generally content with the 1991 proposed regulations, Treasury and the IRS were not. In particular, the government was concerned that by determining Code Sec. 987 gain or loss based on all of the assets of a QBU (including physical assets like machinery that arguably do not fluctuate in value with exchange rate changes), the equity and basis pool method could result in large uneconomic losses that taxpayers could selectively recognize through strategic remittances. Accordingly, Treasury and the IRS introduced a new method of calculating Code Sec. 987 gain and loss—the “foreign exchange exposure pool” (or FEED) method—in 2006 proposed regulations under Code Sec. 987 and ultimately adopted the FEED method as the basis for the never-applicable Code Sec. 987 regulations issued in 2016. The FEED method generally requires tracking historic exchange rates for non-financial assets (“historic assets”) in order to determine Code Sec. 987 gain or loss in a manner that does not attribute foreign currency gain or loss to such historic items. Similarly, elements of Code Sec. 987 income and loss, most notably cost

recovery allowances like depreciation and cost of goods sold (COGS), were translated at historic rates instead of the yearly average exchange rate.

The 2024 Final Regulations, which clocked in at about 105,000 words across 325 pages, adopted the FEED method as the basis for calculating Code Sec. 987 gain and loss, and translating Code Sec. 987 income and loss. The final regulations also adopted the basic architecture for applying Code Sec. 987, including the definitions of a Code Sec. 987 QBU, the transfer and remittance concepts, and the rules for determining termination of a Code Sec. 987 QBU. Additionally, in an effort to relieve some of the burden of applying the FEED method and allow taxpayers to align Code Sec. 987 calculations with financial accounting determinations, the 2024 Final Regulations provide taxpayers with an array of elections. Most notably, a taxpayer could make an election (the “Current Rate Election”)¹ to translate all items attributable to a Code Sec. 987 QBU at the yearly average exchange rate for purposes of calculating Code Sec. 987 gain or loss and translating Code Sec. 987 income or loss. Because the Current Rate Election could result in uneconomic Code Sec. 987 gain and loss however (under Treasury's view of the 1991 Proposed Regulations), a taxpayer applying the Current Rate Election generally is subject to loss suspension rules in Reg. §1.987-11 that generally only permit recognition of Code Sec. 987 to the extent of (future) Code Sec. 987 gains recognized. The loss suspension rules, as well as older final regulations under Reg. §1.987-12 that provide for deferral of Code Sec. 987 gain or loss where there is a successor QBU to a Code Sec. 987 QBU, are themselves suspended, however, for a taxpayer that makes an election (the Annual Recognition Election) to recognize all Code Sec. 987 gain or loss on an annual basis.²

Notice 2026-17 Modifications to the 2024 Final Regulations

Under Notice 2026-17, a Code Sec. 987 QBU owner may elect to apply the “equity and basis pool method” for determining unrecognized Code Sec. 987 gain or loss. Under this method, which closely mimics the approach in the 1991 Proposed Regulations, unrecognized Code Sec. 987 gain or loss equals the equity pool on the last day of the taxable year, translated into the owner's functional currency at the spot rate on that day, reduced by the basis pool on the last day of the taxable year.³ The equity and basis pools are both increased by items of income and gain with respect to the QBU and transfers to the QBU

and decreased by items of deduction and loss with respect to the QBU and transfers from the QBU.⁴ Because the equity pool is determined in the QBU's functional currency and the basis pool is determined in the owner's functional currency, items must be translated into the owner's functional currency to determine the balance of the basis pool. Generally, income, gain, deduction, and loss are translated at the yearly average exchange rate, and the basis of transferred property is translated at the spot rate on the date of transfer. Income, gain, deduction, and loss of a Code Sec. 987 QBU generally are also translated into the owner's functional currency at the yearly average exchange rate for purposes of determining the owner's income and loss attributable to the QBU.

Code Sec. 987 gain or loss is recognized based on the remittance proportion with respect to a QBU. As under the 2024 Final Regulations, a remittance is a net positive transfer from a Code Sec. 987 QBU during the course of a year. The remittance proportion is the amount of the remittance with respect to the QBU divided by the sum of (1) the equity pool on the last day of the year, (2) the aggregate amount of the QBU's liabilities on the last day of the year, and (3) the amount of the remittance.⁵ The amount of Code Sec. 987 gain or loss recognized in a year with respect to a Code Sec. 987 QBU is determined by multiplying the remittance proportion by the equity pool, translated into the owner's functional currency at the spot rate on the last day of the year, reduced by the product of the remittance proportion and the basis pool.

Notwithstanding the new option for determining Code Sec. 987 gain or loss under the equity and basis pool method, most of the infrastructure of the 2024 Final Regulations would remain intact, apart from the rules in Reg. §1.987-3-5 relating to translation of Code Sec. 987 income and loss and calculation and recognition of Code Sec. 987 gain or loss. This includes the definition of a QBU,⁶ the rules regarding QBU terminations,⁷ the loss suspension rules,⁸ and the gain and loss deferral rules on certain QBU terminations.⁹ Additionally, Notice 2026-17 specifically provides that a taxpayer may elect to apply the Code Sec. 988 mark-to-market method of accounting in Reg. §1.987-3(b)(4)(2) to Code Sec. 988 transactions of a Code Sec. 987 QBU and the Annual Recognition Election in Reg. §1.987-5(b)(2).

It is notable that although Notice 2026-17 generally follows the 1991 Proposed Regulations in key regards, it does not seem to contemplate taxpayers applying an "earnings-only" variant of the 1991 Proposed Regulations as was previously widely adopted by taxpayers. Under an

earnings-only approach to the 1991 Proposed Regulations, only earnings of the QBU—and not contributed capital—is taken into account in determining Code Sec. 987 gain or loss. By contrast, Notice 2026-17 specifies that transfers to and from a QBU are taken into account in determining equity and basis pools. Accordingly, it would seem that taxpayers that have followed an earnings-only approach will need to modify their Code Sec. 987 method even if they elect under Notice 2026-17 to apply the equity and basis pool method.

Overall, Notice 2026-17 represents welcome relief for taxpayers who have grown accustomed to the 1991 Proposed Regulations, although it will still require adjustment for taxpayers who have applied an "earnings-only" approach to the 1991 Proposed Regulations. (Given how far Treasury has gone to try to accommodate taxpayer concerns, it is almost surprising that "earnings-only" was not an option.)

Opting Out of Code Sec. 987(3) at the CFC Level

As foreshadowed in the preamble to the 2024 Final Regulations, Notice 2026-17 indicates that Treasury and the IRS are considering rules that would allow taxpayers to elect out of the application of Code Sec. 987(3) at the CFC level. Under this election, Code Sec. 987 gain or loss would not be determined or recognized with respect to a Code Sec. 987 QBU owned by a CFC. The QBU owner would still be required to apply Code Secs. 987(1) and (2), which provide for the determination of the income of the Code Sec. 987 QBU in the QBU's functional currency and the translation of such income into the owner's functional currency at the yearly average exchange rate.¹⁰

Unlike the election to apply the equity and basis pool method, the election to forego application of Code Sec. 987(3) at the CFC level may not yet be relied on by taxpayers. Notice 2026-17 does, however, indicate that Treasury and the IRS “expect that taxpayers will similarly be permitted to rely on the rules relating to the application of section 987(3) to CFCs ...” that will be included in future guidance described in the notice.¹¹ A taxpayer that does make the CFC election would be required to take into account unrecognized Code Sec. 987 gain or loss related to pre-transition years ratably over a 120-month period.¹² Additionally, if a CFC to which the election applies ever engaged in an inbound asset reorganization or liquidation described in Reg. §1.367(b)-3(a), the taxpayer would be required to “account for” (presumably through an income inclusion) foreign currency gain or loss that is built into inbound asset basis and that would have been accounted for in Code Sec. 987 gain or loss if Code Sec. 987(3) applied.¹³

Conclusion

Overall, Notice 2026-17 represents welcome relief for taxpayers who have grown accustomed to the 1991 Proposed Regulations, although it will still require adjustment for taxpayers who have applied an “earnings-only” approach to the 1991 Proposed Regulations. (Given how far Treasury has gone to try to accommodate taxpayer concerns, it is almost surprising that “earnings-only” was not an option.) In any case, transition to the equity and basis pool method should be straightforward, as taxpayers may simply roll unrecognized Code Sec. 987 gain or loss under their prior method into the basis pool.¹⁴ Overall, compliance should be considerably less burdensome than under the unmodified 2024 Final Regulations, although taxpayers will not be able to forget those regulations completely, as the key rules related to the basic architecture of the regulations—as well as the various loss suspension and gain and loss deferral rules—will remain in effect.

ENDNOTES

¹ Reg. §1.987-1(d)(2).

² Reg. §1.987-11(c)(1).

³ Notice 2026-13, IRB 2026-6, section 3.04.

⁴ *Id.* at sections 3.05 and 3.06.

⁵ *Id.* at section 3.09.

⁶ Reg. §1.987-1.

⁷ Reg. §1.987-8.

⁸ Reg. §1.987-11.

⁹ Reg. §1.987-12.

¹⁰ *Id.* at section 5.

¹¹ *Id.* at section 6.

¹² *Id.* at section 5.05.

¹³ *Id.*

¹⁴ *Id.* at section 3.09.

This article is reprinted with the publisher’s permission from INTERNATIONAL TAX JOURNAL, a bimonthly journal published by CCH Incorporated. Copying or distribution without the publisher’s permission is prohibited. To subscribe to INTERNATIONAL TAX JOURNAL or other journals, please call 1-800-344-3734. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.