Foreign Currency Guidance Deferred Again

By Peter D. Baum, CPA, Partner

The IRS recently announced that it intends to defer again, by one additional year, the applicability dates of 2016 foreign currency final regulations and related 2019 final regs. This deferral leaves the taxpayer with outdated guidance on how to compute the gain or loss on the value of the asset and/or on changes in foreign currency. If you and/or your business have gains and/or losses related to foreign currency, this article may help you anticipate what's on the horizon.

The 2016 Final Regulations provide guidance to corporations and individuals on determining taxable income or loss of a qualified business unit (QBU) whose functional currency differs from its owner (an IRC Section 987 QBU). They also provide guidance on the timing, amount, character and source of any IRC Section 987 gain or loss arising from such a QBU. The temporary regulations, some of which were finalized in T.D. 9857 in 2019, provided rules for deferring IRC Section 987 gain or loss in connection with certain IRC Section 987 QBU terminations and transactions involving partnerships, as well as other related elections and special rules. The 2016 Final Regulations were originally intended to apply to tax years beginning after December 7, 2016, but implementation has been extended each year. The latest extension means that the regulations will be applicable for years beginning after December 7, 2023 (effectively January 1, 2024).

The prescribed approach of the 2016 Final Regulations for computing taxable income or loss and IRC Section 987 gain or loss of an IRC Section 987 QBU **differs entirely from that used by most taxpayers for more than 30 years.** The regulations also impose substantial recordkeeping and compliance requirements.

Section 987 Basics

The goal of the Section 987 rules is to separate out what income or loss of a taxpayer is based on changes in the value of an asset and what is based on changes in the foreign currency in which the asset is held.

Example: If Taxpayer A purchases property for 100 shillings when the shilling is worth \$1.00 and sells the property for 200 shillings when the shilling is worth \$0.75, he can be viewed as realizing an exchange loss of \$25 because of the decline in the dollar value of his 100 shilling basis in the property from \$100 to \$75. He realizes a gain, however, of \$75 on the sale itself — the dollar value at the exchange rate in effect at the time of the sale of his 100 shilling profit. The \$25 exchange loss should reduce the \$75 overall gain, for tax purposes, to \$50. And, because of the functional currency rules, this is exactly what happens: Taxpayer A is viewed as purchasing property for \$100 (100 shillings × \$1.00 exchange rate in effect on the purchase date) and as selling it for \$150 (200 shillings × \$0.75 exchange rate in effect on the sale date). Thus, his taxable gain on the sale is \$50 — and the exchange loss has indirectly offset the overall gain.

Why These Regulations Are Such a Big Change

As noted above, the delayed regulations would make significant changes to the way the foreign currency gain or loss of a business unit of the taxpayer is calculated.

Under the original 1991 Proposed Regulations, foreign currency gain or loss is based on the annual income or loss of the QBU, translated at average annual exchange rates. The exchange gain or loss under IRC 987 is recognized when the QBU makes, or is deemed to make, a transfer back to its owner.

Under the 2019 revised Proposed Regulations and the 2016 Final Regulations, the translation of income and expenses of the 987 QBU into the owner's functional currency occurs on an item-by-item basis, creating a significantly larger compliance burden that goes against how foreign currency exchange gain or loss has historically been tracked. Concerns about the ability to effectively apply these rules are what has caused the delay in implementation.

Note that the IRS has stated that a virtual currency/cryptocurrency isn't treated as foreign currency that can generate foreign currency gain or loss for U.S. federal tax purposes, so the changes to the regulations do not affect crypto transactions.

Implications

The deferral was expected and is helpful because it gives taxpayers time to create and implement the complex systems and processes necessary to transition to the 2016 Final Regulations. The most recent notice does not mention that the IRS is considering changes to these regulations to simplify the rules (although it has been mentioned in prior deferral notices). Until the 2016 Final Regulations apply, taxpayers must compute IRC Section 987 gain or loss under a reasonable method and apply the deferral-event and outbound-loss-event rules of Treas. Reg. Section 1.987-12.

Contact Us

The tax specialists at PKF O'Connor Davies are continuously monitoring tax developments from the federal and state governments. Contact your client relationship manager or:

Peter D. Baum, CPA
Partner
pbaum@pkfod.com | 914.341.7088