AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

(f) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88870, Dec. 8, 2016]

§ 1.987–3 Determination of section 987 taxable income or loss of an owner of a section 987 QBU.

(a) *In general.* This section provides rules for determining the taxable income or loss, or the earnings and profits, of an owner of a section 987 QBU (hereafter, section 987 taxable income or loss). Paragraph (b) of this section provides rules for determining items of income, gain, deduction, and loss, which generally must be determined in the section 987 QBU's functional currency. Paragraph (c) of this section provides rules for translating each item determined under paragraph (b) of this section into the functional currency of the owner of the section 987 QBU, if necessary. Paragraph (e) of this section provides examples illustrating the application of the rules of this section.

(b) *Determination of each item of income, gain, deduction, or loss in the section 987 QBU's functional currency*—(1) *In general.* Except as otherwise provided in this section, a section 987 QBU shall determine each item of income, gain, deduction, or loss of such section 987 QBU in its functional currency under Federal income tax principles.

(2) *Translation of items of income, gain, deduction, or loss that are denominated in a nonfunctional currency*—(i) *In general.* Except as otherwise provided in paragraphs (b)(2)(ii) and (b)(4) of this section, an item of income, gain, deduction, or loss that is denominated in (or determined by reference to) a nonfunctional currency (including the functional currency of the owner) shall be translated into the section 987 QBU's functional currency at the spot rate (as defined in §1.987–1(c)(1)) on the date such item is properly taken into account, subject to the limitation under §1.987–1(c)(1)(ii)(B) regarding the use of a spot rate convention. Examples 1, 2 and 6 of paragraph (e) of this section illustrate the application of this paragraph (b)(2)(i).

(ii) [Reserved]. For further guidance, see §1.987–3T(b)(2)(ii).

(3) *Determination in the case of a section 987 QBU owned through a section 987 aggregate partnership*—(i) *In general.* Except as otherwise provided in this paragraph (b)(3), the taxable income or loss of a section 987 aggregate partnership, and the distributive share of any owner that is a partner in such partnership, shall be determined in accordance with the provisions of subchapter K of the Internal Revenue Code.

(ii) *Determination of each item of income, gain, deduction, or loss in the eligible QBU's functional currency.* A section 987 aggregate partnership generally shall determine each item of income, gain, deduction, or loss reflected on the books and records of each of its eligible QBUs under §1.987–2(b) in the functional currency of each such QBU.

(iii) *Allocation of items of income, gain, deduction, or loss of an eligible QBU.* A section 987 aggregate partnership shall allocate the items of income, gain, deduction, or loss of each eligible QBU among its partners in accordance with each partner's distributive share of such income, gain, deduction, or loss as determined under subchapter K of the Internal Revenue Code.

(iv) *Translation of items into the owner's functional currency.* To the extent the items referred to in paragraph (b)(3)(iii) of this section are allocated to a partner, the partner shall adjust the items to conform to Federal income tax principles and translate the items into the partner's functional currency as provided in paragraph (c) of this section.

(4) [Reserved]. For further guidance, see §1.987–3T(b)(4).

(c) *Translation of items of income, gain, deduction, or loss of a section 987 QBU into the owner's functional currency*—(1) *In general.* Except as otherwise provided in this section, the exchange rate to be used by an owner in translating an item of income, gain, deduction, or loss attributable to a section 987 QBU into the owner's functional currency, if necessary, shall be the yearly average exchange rate (as defined in §1.987–1(c)(2)) for the taxable year. However, an owner of a section 987 QBU that has elected under §1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates must use the spot rate (as defined in §1.987–1(c)(1)) for the date

each item is properly taken into account.

(2) *Exceptions*—(i) *Recovery of basis with respect to historic assets.* Except as otherwise provided in this section, the exchange rate to be used by the owner in translating any recovery of basis (whether through a sale or exchange; deemed sale or exchange; cost recovery deduction such as depreciation, depletion or amortization; or otherwise) with respect to a historic asset (as defined in §1.987–1(e)) shall be the historic rate as determined under §1.987–1(c)(3) for the property to which such recovery of basis is attributable.

(ii) [Reserved]. For further guidance, see §1.987–3T(c)(2)(ii).

(iii) *Gain or loss on the sale, exchange or other disposition of an interest in a section 987 aggregate partnership.* [Reserved]

(iv) *Cost of goods sold computation*—(A) *General rule—simplified inventory method.* Cost of goods sold (COGS) for a taxable year shall be translated into the functional currency of the owner at the yearly average exchange rate (as defined in §1.987–1(c)(2)) for the taxable year and adjusted as provided in paragraph (c)(3) of this section.

(B) *Election to use the historic inventory method.* In lieu of using the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section, the owner of a section 987 QBU may elect under this paragraph (c)(2)(iv)(B) to translate inventoriable costs (including current-year inventoriable costs and costs that were capitalized into inventory in prior years) that are included in COGS at the historic rate as determined under §1.987–1(c)(3) for each such cost. As described in §1.987–1(c)(1)(iii), a taxpayer that elects to use spot rates in lieu of yearly average exchange rates as provided in that section will be deemed to have made the election described in this paragraph (c)(2)(iv)(B).

(v) [Reserved]. For further guidance, see §1.987–3T(c)(2)(v) through (d).

(3) *Adjustments to COGS required under the simplified inventory method*—(i) *In general.* An owner of a section 987 QBU that uses the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section must make the adjustment described in paragraph (c)(3)(ii) of this section. In addition, the owner must make the adjustment described in paragraph (c)(3)(iii) of this section with respect to any inventory for which the section 987 QBU does not use the LIFO inventory method (as described in section 472) and must make the adjustment described in paragraph (c)(3)(iv) of this section with respect to any inventory for which the section 987 QBU uses the LIFO inventory method. An owner of a section 987 QBU that uses the simplified inventory method must make all of the applicable adjustments described in paragraphs (c)(3)(ii) through (iv) with respect to the section 987 QBU even in taxable years in which the amount of COGS is zero.

(ii) *Adjustment for cost recovery deductions included in inventoriable costs.* The translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) to reflect the difference between the historic rates appropriate for translating cost recovery deductions attributable to other historic assets and the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section, to the extent any such cost recovery deductions are included in inventoriable costs for the taxable year. The adjustment shall be included as an adjustment to translated COGS computed under paragraph (c)(2)(iv)(A) of this section in full in the year to which the adjustment relates and shall not be allocated between COGS and ending inventory. The adjustment for each cost recovery deduction shall be computed as the product of:

(A) The cost recovery deduction, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate specified in paragraph (c)(2)(i) of this section for translating the cost recovery deduction (that is, the historic rate for the property to which such deduction is attributable) less the exchange rate used to translate COGS under the simplified inventory method described in paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iii) *Adjustment to beginning inventory for non-LIFO inventory.* In the case of

inventory with respect to which a section 987 QBU does not use the LIFO inventory method (non-LIFO inventory), the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The ending non-LIFO inventory included on the closing balance sheet for the preceding year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§1.987–4(e)(2)(ii) and 1.987–1(c)(3)(i)(C) that is used for translating ending inventory on the closing balance sheet for the preceding year (that is, the yearly average exchange rate for the preceding year) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(iv) *Adjustment for year of LIFO liquidation.* In the case of inventory with respect to which a section 987 QBU uses the LIFO inventory method, for each LIFO layer liquidated in whole or in part during the taxable year, the translated COGS amount computed under paragraph (c)(2)(iv)(A) of this section must be increased or decreased (as appropriate) by the product of:

(A) The amount of the LIFO layer liquidated during the taxable year, expressed in the functional currency of the section 987 QBU; and

(B) The exchange rate described in §§1.987–4(e)(2)(ii) and 1.987–1(c)(3)(i)(C) that is used for translating such LIFO layer (that is, the yearly average exchange rate for the year such LIFO layer arose) less the exchange rate used to translate COGS under paragraph (c)(2)(iv)(A) of this section (that is, the yearly average exchange rate for the taxable year).

(d) [Reserved]. For further guidance, see §1.987–3T(c)(2)(v) through (d).

(e) *Examples.* The following examples illustrate the application of this section. For purposes of the examples, U.S. Corp is a domestic corporation that uses the calendar year as its taxable year and has the U.S. dollar as its functional currency. Except as otherwise indicated, U.S. Corp is the owner of Business A, a section 987 QBU with the euro as its functional currency, and elects under paragraph (c)(2)(iv)(B) of this section to use the historic inventory method with respect to Business A but does not make any other elections under section 987. However, where it is specified that U.S. Corp elects to use spot rates in lieu of yearly average exchange rates under §1.987–1(c)(1)(iii), U.S. Corp also elects under §1.987–1(c)(1)(ii) to use a spot rate convention. Under this convention, sales booked during a particular month are translated at the average of the spot rates on the first and last day of the preceding month (the ''convention rate''). Exchange rates used in these examples are selected for the purpose of illustrating the principles of this section. No inference (for example, whether a currency is hyperinflationary or not) is intended by their use. See §1.987–4(g) for an illustration of the simplified inventory method described in paragraphs (c)(2)(iv)(A) and (c)(3) of this section.

Example 1. Business A properly accrues £100 of income from the provision of services. Under paragraph (b)(2)(i) of this section, the £100 is translated into €90 at the spot rate (as defined in §1.987–1(c)(1)) on the date of accrual, without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €90 of income is translated into dollars at the rate provided in paragraph (c)(1) of this section.

Example 2. Business A sells a historic asset consisting of non-inventory property for £100. Under paragraph (b)(2)(i) of this section, the £100 amount realized is translated into €85 at the spot rate (as defined in §1.987–1(c)(1)) on the sale date without the use of a spot rate convention. In determining U.S. Corp's taxable income, the €85 is translated into dollars at the rate provided in paragraph (c)(1) of this section. The euro basis of the property is translated into dollars at the rate provided in paragraph (c)(2)(i) of this section (that is, the historic rate as determined under §1.987–1(c)(3)).

Example 3. (i) Business A uses a first-in, first-out (FIFO) method of accounting for inventory. Business A sells 1,200 units of inventory in 2021 for €3 per unit. Business A's gross sales are translated under paragraph (c)(1) of this section at the yearly average exchange rate for the year of the sale. The yearly average exchange rate is €1 = $1.02 for 2020 and €1 = $1.05 for 2021. Thus, Business A's dollar gross sales will be computed as follows:

GROSS SALES

[2021]

Month	Number of units	Amount in €	€/$ yearly average rate	Amount in $
Jan	100	300	€1 = $1.05	315.00
Feb	200	600	€1 = $1.05	630.00
March	0	0	€1 = $1.05	0
April	200	600	€1 = $1.05	630.00
May	100	300	€1 = $1.05	315.00
June	0	0	€1 = $1.05	0
July	100	300	€1 = $1.05	315.00
Aug	100	300	€1 = $1.05	315.00
Sept	0	0	€1 = $1.05	0
Oct	0	0	€1 = $1.05	0
Nov	100	300	€1 = $1.05	315.00
Dec	300	900	€1 = $1.05	945.00
	1,200			3,780.00

(ii) The purchase price for each inventory unit was €1.50. Under §1.987–1(c)(3)(i) and paragraph (c)(2)(iv)(B) of this section, the basis of each item of inventory is translated into dollars at the yearly average exchange rate for the year the inventory was acquired.

OPENING INVENTORY AND PURCHASES

[2021]

Month	Number of units	Amount in €	€/$ yearly average rate	Amount in $
Opening inventory (purchased in December 2020)	100	150	€1 = $1.02	153.00
Purchases in 2021:				
Jan	300	450	€1 = $1.05	472.50
Feb	0	0	€1 = $1.05	0
March	0	0	€1 = $1.05	0
April	300	450	€1 = $1.05	472.50
May	0	0	€1 = $1.05	0
June	0	0	€1 = $1.05	0
July	300	450	€1 = $1.05	472.50
Aug	0	0	€1 = $1.05	0
Sept	0	0	€1 = $1.05	0
Oct	0	0	€1 = $1.05	0
Nov	300	450	€1 = $1.05	472.50
Dec	0	0	€1 = $1.05	0
	1,200			1,890.00

(iii) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in 2020 ($153.00), the 300 units purchased in January 2021 ($472.50), the 300 units purchased in April 2021 ($472.50), the 300 units purchased in July 2021 ($472.50), and 200 of the 300 units purchased in November 2021 ($315.00). Accordingly, Business A's translated dollar COGS for 2021 is $1,885.50. Business A's opening inventory for 2022 is 100 units of inventory with a translated dollar basis of $157.50.

(iv) Accordingly, for purposes of section 987 Business A has gross income in dollars of $1,894.50 ($3,780.00—$1,885.50).

Example 4. (i) The facts are the same as in *Example 3* except that U.S. Corp properly elects under paragraph §1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average exchange rates. As a result, under paragraph (c)(3) of this section, U.S. Corp uses the convention rate to translate items of income, gain, deduction, or loss where such rate is appropriate. Thus, Business A's dollar gross sales will be computed as follows:

GROSS SALES

[2021]

Sales	Number of units	Amount in €	€/$ convention rate	Amount in $
Jan	100	300	€1 = $1.00	300
Feb	200	600	€1 = $1.05	630
March	0	0	€1 = $1.03	0
April	200	600	€1 = $1.02	612
May	100	300	€1 = $1.04	312
June	0	0	€1 = $1.05	0
July	100	300	€1 = $1.06	318
Aug	100	300	€1 = $1.05	315
Sept	0	0	€1 = $1.06	0
Oct	0	0	€1 = $1.07	0
Nov	100	300	€1 = $1.08	324
Dec	300	900	€1 = $1.08	972
	1,200	.....	.....	3,783

(ii) As in *Example 3*, the purchase price for each inventory unit was €1.50. Under §1.987–3(c)(2)(iv)(B), U.S. Corp uses the convention rate as the historic rate in determining COGS.

OPENING INVENTORY AND PURCHASES

[2021]

Month	Number of units	Amount in €	€/$ convention rate	Amount in $
Opening inventory (purchased in December 2020)	100	150	€1 = $1.02	153
Purchases in 2021:				
Jan	300	450	€1 = $1.00	450
Feb	0	0	€1 = $1.05	0
March	0	0	€1 = $1.03	0
April	300	450	€1 = $1.02	459
May	0	0	€1 = $1.04	0
June	0	0	€1 = $1.05	0
July	300	450	€1 = $1.06	477
Aug	0	0	€1 = $1.05	0
Sept	0	0	€1 = $1.06	0
Oct	0	0	€1 = $1.07	0
Nov	300	450	€1 = $1.08	486
Dec	0	0	€1 = $1.08	486
	1,200	.....	.....	1,872

(iii) As set forth in (i), Business A's gross sales are $3,783.

(iv) Because Business A uses a FIFO method for inventory, Business A is considered to have sold in 2021 the 100 units of opening inventory purchased in December 2020 ($150), the 300 units purchased in January 2021 ($450), the 300 units purchased in April 2021 ($459), the 300 units purchased in July 2021 ($477), and 200 of the 300 units purchased in November 2021 ($324). Thus, Business A's COGS is $1,860.

(v) Accordingly, Business A has gross income in dollars of $1,923 ($3,783 − $1,860).

Example 5. The facts are the same as in *Example 3* except that during 2021, Business A incurred €100 of depreciation expense with respect to a truck. No portion of the depreciation expense is an inventoriable cost. The truck was purchased on January 15, 2020. The yearly average exchange rate for 2020 was €1 = $1.02. Under paragraph (c)(2)(i) of this section, the €100 of depreciation is translated into dollars at the historic rate. Under §1.987–1(c)(3)(i), the historic rate is the yearly average rate for 2020. Accordingly, U.S. Corp takes into account depreciation of $102 with respect to Business A in 2021.

Example 6. The facts are the same as in *Example 5* except that the €100 of depreciation expense incurred during 2021 with respect to the truck is an inventoriable cost. As a result, the depreciation expense is capitalized into the 1,200 units of inventory purchased by Business A in 2021. Of those 1,200 units, 1,100 units are sold during the year, and 100

units become ending inventory. The portion of depreciation expense capitalized into inventory that is sold during 2021 is reflected in Business A's euro COGS and is translated at the €1 = $1.02 yearly average exchange rate for 2020, the year in which the truck was purchased. The portion of the depreciation expense capitalized into the 100 units of ending inventory is not taken into account in 2021 but, rather, will be taken into account in the year the ending inventory is sold, translated at the €1 = $1.02 yearly average exchange rate for 2020.

Example 7. Business A purchased raw land on October 16, 2020, for €8,000 and sold the land on November 1, 2021, for €10,000. The yearly average exchange rate was €1 = $1.02 for 2020 and €1 = $1.05 for 2021. Under paragraph (c)(1) of this section, the amount realized is translated into dollars at the yearly average exchange rate for 2021 (€10,000 × $1.05 = $10,500). Under paragraph (c)(2)(i) of this section, the basis is determined at the historic rate for 2020, which is the yearly average rate under section §1.987–1(c)(3)(i) for such year (€8,000 × $1.02 = $8,160). Accordingly, the amount of gain reported by U.S. Corp on the sale of the land is $2,340 ($10,500 − $8,160).

Example 8. The facts are the same as in *Example 7* except that Business A properly elects under paragraph §1.987–1(c)(1)(iii) to use spot rates in lieu of yearly average rates. Accordingly, the amount realized will be translated at the convention rate for the date of sale, and the basis will be translated at the convention rate for the date of purchase. The convention rate is €1 = $1.01 for October 2020 and is €1 = $1.08 for November 2021. Under these facts, the amount realized, translated into dollars at the convention rate for November 2021, is $10,800 (€10,000 × $1.08), and the basis, translated at the convention rate for October 2020, is $8,080 (€8,000 × $1.01). The amount of gain reported by U.S. Corp on the sale of the land is $2,720 ($10,800 − $8,080).

Example 9 through Example 14 [Reserved]. For further guidance, see §1.987–3T(e), *Example 9* through *Example 14*.

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88870, Dec. 8, 2016]

§ 1.987–3T Determination of section 987 taxable income or loss of an owner of a section 987 QBU (temporary).

(a) through (b)(2)(i) [Reserved]. For further guidance, see §1.987–3(a) through (b)(2)(i).

(ii) *No translation of basis or amount realized with respect to a specified owner functional currency transaction treated as a historic asset.* If the acquisition of a historic asset gives rise to a specified owner functional currency transaction described in paragraph (b)(4)(ii) of this section, the basis of the historic asset, and any amount realized on a disposition of the historic asset, is not translated if the amount is denominated in the owner's functional currency.

(3) [Reserved]. For further guidance, see §1.987–3(b)(3).

(4) *Special rule for section 988 transactions*—(i) *In general.* Section 988 and the regulations thereunder apply to section 988 transactions of a section 987 QBU. For this purpose, whether a transaction is a section 988 transaction is determined by reference to the functional currency of the section 987 QBU. (But see paragraph (b)(4)(ii) of this section, providing that specified owner functional currency transactions are not treated as section 988 transactions.) However, except as provided in paragraph (b)(4)(iii)(A) of this section, section 988 gain or loss is determined in, and by reference to, the functional currency of the owner of the section 987 QBU rather than the functional currency of the section 987 QBU. Accordingly, in determining section 988 gain or loss of a section 987 QBU with respect to a section 988 transaction of the section 987 QBU, the amounts required under section 988 and the regulations thereunder to be translated on the applicable booking date or payment date with respect to the section 988 transaction are translated into the owner's functional currency at the rate required under section 988 and the regulations thereunder.

(ii) *Specified owner functional currency transactions not treated as section 988 transactions.* Transactions of a section 987 QBU described in sections 988(c)(1)(B)(i), 988(c)(1)(B)(ii), and 988(c)(1)(C) (including the acquisition of nonfunctional currency as described in §1.988–1(a)(1)), other than transactions described in paragraph (b)(4)(iii)(A) of this section, that are denominated in (or determined by reference to) the owner's functional currency (specified owner functional currency transactions) are not treated as section 988 transactions. Thus, no currency gain or loss is recognized by a section 987 QBU under section 988 with respect to such transactions.