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depreciation expense is €1 = $1.00. The spot rate on the date that Business A paid its foreign income taxes was €1 = $1.60.

(ii) *Analysis.* Because U.S. Corp has elected to translate foreign income taxes at the spot rate on the date such taxes were paid rather than at the yearly average exchange rate, U.S. Corp must make the adjustments described in paragraph (c)(2)(v) of this section. Accordingly, U.S. Corp determines its section 987 taxable income by reducing the section 987 taxable income or loss that otherwise would be determined under this section by €15, translated into U.S. dollars at the yearly average exchange rate (€1 = $1.50), and increasing the resulting amount by €15, translated using the same exchange rate that is used to translate the creditable taxes into U.S. dollars under section 986(a) (€1 = $1.60). Following these adjustments, Business A's section 987 taxable income for 2021 is $96.50, computed as follows:

	Amount in €	Translation rate	Amount in $
Revenue	€100	€1 = $1.50	$150.00
General Expenses	(30)	€1 = $1.50	(45.00)
Depreciation	(10)	€1 = $1.00	(10.00)
Tentative section 987 taxable income	€60		$95.00
Adjustments under paragraph (c)(2)(v) of this section:			
Decrease by €15 tax translated at yearly average exchange rate (€1 = $1.50)			($22.50)
Increase by €15 tax translated at spot rate on payment date (€1 = $1.60)			24.00
Section 987 taxable income			$96.50

(f) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

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

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

§ 1.987–4 Determination of net unrecognized section 987 gain or loss of a section 987 QBU.

(a) *In general.* The net unrecognized section 987 gain or loss of a section 987 QBU shall be determined by the owner annually as provided in paragraph (b) of this section in the owner's functional currency. Only assets and liabilities reflected on the books and records of the section 987 QBU under §1.987–2(b) shall be taken into account.

(b) *Calculation of net unrecognized section 987 gain or loss.* Net unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall equal the sum of:

(1) The section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years to which these regulations apply as determined in paragraph (c) of this section, and

(2) The section 987 QBU's unrecognized section 987 gain or loss for the current taxable year as determined in paragraph (d) of this section.

(c) *Net accumulated unrecognized section 987 gain or loss for all prior taxable years*—(1) *In general.* A section 987 QBU's net accumulated unrecognized section 987 gain or loss for all prior taxable years is the aggregate of the amounts determined under §1.987–4(d) for all prior taxable years to which these regulations apply, reduced by the amounts taken into account under §1.987–5 upon remittances for all such prior taxable years.

(2) [Reserved]. For further guidance, see §1.987–4T(c)(2).

(d) *Calculation of unrecognized section 987 gain or loss for a taxable year.* The unrecognized section 987 gain or loss of a section 987 QBU for a taxable year shall be determined under paragraphs (d)(1) through (8) of this section.

(1) *Step 1: Determine the change in the owner functional currency net value of the section 987 QBU for the taxable year*—(i) *In general.* The change in the owner functional currency net value of the section 987 QBU for the taxable year shall equal—

(A) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the taxable year; less

(B) The owner functional currency net value of the section 987 QBU, determined in the functional currency of the owner under paragraph (e) of this section, on the last day of the preceding taxable year. This amount shall be zero in the case of the section 987 QBU's first taxable year.

(ii) *Year section 987 QBU is terminated.* If a section 987 QBU is terminated within the meaning of §1.987–8 during an owner's taxable year, the owner functional currency net value of the section 987 QBU as provided in paragraph (d)(1)(i)(A) of this section shall be determined on the date the section 987 QBU is terminated.

(2) *Step 2: Increase the amount determined in step 1 by the amount of assets transferred from the section 987 QBU to the owner*—(i) *In general.* The amount determined in paragraph (d)(1) of this section shall be increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section.

(ii) *Assets transferred from the section 987 QBU to the owner during the taxable year.* The assets transferred from the section 987 QBU to the owner for the taxable year shall equal the sum of:

(A) The amount of the section 987 QBU's functional currency and the aggregate adjusted basis of all marked assets (as defined in §1.987–1(d)), after taking into account §1.988–1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the spot rate (as defined in §1.987–1(c)(1)) applicable to the date of transfer; and

(B) The aggregate adjusted basis of all historic assets (as defined in §1.987–1(e)), after taking into account §1.988–1(a)(10), transferred to the owner during the taxable year determined in the functional currency of the section 987 QBU and translated into the owner's functional currency at the historic rate for each such asset (as defined in §1.987–1(c)(3)).

(3) *Step 3: Decrease the amount determined in steps 1 and 2 by the amount of assets transferred from the owner to the section 987 QBU*—(i) *In general.* The aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section shall be decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year determined in the functional currency of the owner as provided in paragraph (d)(3)(ii) of this section.

(ii) *Total of all amounts transferred from the owner to the section 987 QBU during the taxable year.* The total amount of assets transferred from the owner to the section 987 QBU for the taxable year shall equal the aggregate of:

(A) The total amount of functional currency of the owner transferred to the section 987 QBU during the taxable year; and

(B) The adjusted basis, determined in the functional currency of the owner, of any asset transferred to the section 987 QBU during the taxable year (after taking into account §1.988–1(a)(10)).

(4) *Step 4: Decrease the amount determined in steps 1 through 3 by the amount of liabilities transferred from the section 987 QBU to the owner.* The aggregate amount determined in paragraphs (d)(1) through (3) of this section shall be decreased by the aggregate amount of liabilities transferred from the section 987 QBU to the owner during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate (as defined in §1.987–1(c)(1)) applicable on the date of transfer.

(5) *Step 5: Increase the amount determined in steps 1 through 4 by the amount of liabilities transferred from the owner to the section 987 QBU.* The aggregate amount determined in paragraphs (d)(1) through (4) of this section shall be increased by the aggregate amount of liabilities transferred by the owner to the section 987 QBU during the taxable year. The amount of such liabilities shall be translated into the functional currency of the owner at the spot rate

(as defined in §1.987–1(c)(1)) applicable on the date of transfer.

(6) *Step 6: Decrease or increase the amount determined in steps 1 through 5 by the section 987 taxable income or loss, respectively, of the section 987 QBU for the taxable year.* The aggregate amount determined in paragraphs (d)(1) through (5) of this section shall be decreased or increased by the section 987 taxable income or loss, respectively, computed under §1.987–3 for the taxable year.

(7) *Step 7: Increase the amount determined in steps 1 through 6 by any expenses that are not deductible in computing the section 987 taxable income or loss of the section 987 QBU for the taxable year.* The aggregate amount determined under paragraphs (d)(1) through (6) shall be increased by the amount of any expense or loss attributable to a section 987 QBU for the taxable year that is not deductible in computing the section 987 QBU's taxable income or loss for the year, including any foreign income taxes incurred by the section 987 QBU with respect to which the owner claims a credit (translated at the same rate at which such taxes were translated under section 986(a)).

(8) *Step 8: Decrease the amount determined in steps 1 through 7 by the amount of any tax-exempt income.* The aggregate amount determined under paragraphs (d)(1) through (7) shall be decreased by the amount of any income or gain attributable to a section 987 QBU for the taxable year that is not included in computing the section 987 QBU's taxable income or loss for the year.

(e) *Determination of the owner functional currency net value of a section 987 QBU*—(1) *In general.* The owner functional currency net value of a section 987 QBU on the last day of a taxable year shall equal the aggregate amount of functional currency and the adjusted basis of each asset on the section 987 QBU's balance sheet on that day, less the aggregate amount of each liability on the section 987 QBU's balance sheet on that day, in each case translated into the owner's functional currency as provided in paragraph (e)(2) of this section. Such amount shall be determined by:

(i) Preparing a balance sheet for the relevant date from the section 987 QBU's books and records (within the meaning of §1.989(a)–1(d)), as recorded in the section 987 QBU's functional currency and showing all assets and liabilities reflected on such books and records as provided in §1.987–2(b);

(ii) Making adjustments necessary to conform the items reflected on the balance sheet described in paragraph (e)(1)(i) of this section to United States tax accounting principles; and

(iii) Translating the asset and liability amounts on the adjusted balance sheet described in paragraph (e)(1)(ii) of this section into the functional currency of the owner in accordance with paragraph (e)(2) of this section.

(2) *Translation of balance sheet items into the owner's functional currency.* The amount of the section 987 QBU's functional currency, the basis of an asset, or the amount of a liability shall be translated as follows:

(i) *Marked item.* A marked item (as defined in §1.987–1(d)) shall be translated into the owner's functional currency at the spot rate (as defined in §1.987–1(c)(1)) applicable to the last day of the relevant taxable year.

(ii) *Historic item.* A historic item (as defined in §1.987–1(e)) shall be translated into the owner's functional currency at the historic rate (as defined in §1.987–1(c)(3)).

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

(g) *Examples.* The following examples illustrate the provisions 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 dollar as its functional currency. Except as otherwise indicated, U.S. Corp elects under §1.987–3(c)(2)(iv)(B) to use the historic inventory method with respect to all of its section 987 QBUs but does not make other elections under section 987. Exchange rate and tax accounting (for example, depreciation rate) assumptions used in these examples are selected for the purpose of illustrating the principles of this section, and no inference is intended by their use. Additionally, the examples are not intended to demonstrate when activities constitute a trade or business within the meaning of §1.989(a)–1(b)(2)(ii)(A) and §1.989(a)–

1(c) and therefore whether a section 987 QBU is onsidered to exist.

Example 1. (i) On July 1, 2021, U.S. Corp establishes Japan Branch, a section 987 QBU of U.S. Corp that has the yen as its functional currency, and transfers to Japan Branch $1,000 and raw land with a basis of $500. Japan Branch immediately exchanges the $1,000 for ¥100,000. On the same day, Japan Branch borrows ¥10,000. For the taxable year 2021, Japan Branch earns ¥2,000 per month (total of ¥12,000 for the six-month period from July 1, 2021, through December 31, 2021) for providing services and incurs ¥333.33 per month (total of ¥2,000 when rounded for the six-month period from July 1, 2021, through December 31, 2021) of related expenses. Assume that the spot rate on July 1, 2021, is $1 = ¥100; the spot rate on December 31, 2021, is $1 = ¥120; and the average rate for the period of July 1, 2021, to December 31, 2021, is $1 = ¥110. Thus, the ¥12,000 of services revenue when properly translated under §1.987–3(c)(1) at the yearly average exchange rate equals $109.09 (¥12,000 × ($1/¥110)) = $109.09). The ¥2,000 of expenses translated at the same yearly average exchange rate equals $18.18 (¥2,000 × ($1/¥110) = $18.18). Thus, Japan Branch's net income translated into dollars equals $90.91 ($109.09 − $18.18 = $90.91).

(ii) Under paragraph (a) of this section, U.S. Corp must compute the net unrecognized section 987 gain or loss of Japan Branch for 2021. Because this is Japan Branch's first taxable year, the net unrecognized section 987 gain or loss (as defined under paragraph (b) of this section) is the branch's unrecognized section 987 gain or loss for 2021 as determined in paragraph (d) of this section. The calculation under paragraph (d) of this section is made as follows:

(iii) *Step 1.* Under paragraph (d)(1) of this section, U.S. Corp must determine the change in the owner functional currency net value (OFCNV) of Japan Branch for 2021 in dollars. The change in the OFCNV of Japan Branch for 2021 is equal to the OFCNV of Japan Branch determined in dollars on the last day of 2021, less the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year.

(A) The OFCNV of Japan Branch determined in dollars on the last day of the current taxable year is determined under paragraph (e) of this section as the sum of the basis of each asset on Japan Branch's balance sheet on December 31, 2021, less the sum of each liability on Japan Branch's balance sheet on that date, translated into dollars as provided in paragraph (e)(2) of this section.

(B) For this purpose, Japan Branch will show the following assets and liabilities on its balance sheet for December 31, 2021:

(1) ¥120,000;

(2) Raw land with a basis of ¥55,000 ($500 translated under §1.987–2(d)(2) at the historic rate of $1 = ¥110); and

(3) Liabilities of ¥10,000.

(C) Under paragraph (e)(2) of this section, U.S. Corp will translate these items as follows. The ¥120,000 is a marked asset and the ¥10,000 liability is a marked liability (as each is defined in §1.987–1(d)). These items are translated into dollars on December 31, 2021, using the spot rate on December 31, 2021, of $1 = ¥120. The raw land is a historic asset (as defined in §1.987–1(e)) and is translated into dollars under paragraph (e)(2)(ii) of this section at the historic rate, which under §1.987–1(c)(3)(1)(A) is the yearly average exchange rate of $1 = ¥110 applicable to the year the land was transferred to the QBU. Thus, the OFCNV of Japan Branch on December 31, 2021, in dollars is $1,416.67 determined as follows:

Assets	Amount in ¥	Translation rate	Amount in $
Yen	120,000	$1 = ¥120 (spot rate—12/31/21)	$1,000.00
Land	55,000	1 = ¥110 (yearly average rate—2021)	500.00
Total assets			1,500.00
Liabilities:			
Bank Loan	10,000	1 = ¥120 (spot rate—12/31/21)	83.33
Total liabilities			83.33
2021 ending OFCNV			1,416.67

(D) Under paragraph (d)(1) of this section, the change in OFCNV of Japan Branch for 2021 is equal to the OFCNV of the branch determined in dollars on December 31, 2021, ($1,416.67) less the OFCNV of the branch determined in dollars on the last day of the preceding taxable year. Because this is the first taxable year of Japan Branch, the OFCNV of Japan Branch determined in dollars on the last day of the preceding taxable year is zero under paragraph (d)(1)(i)(B) of this section. Accordingly, the change in OFCNV of Japan Branch for 2021 is $1,416.67.

(iv) *Step 2.* Under paragraph (d)(2) of this section, the aggregate amount determined in paragraph (d)(1) of this section (step 1) is increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from the section 987 QBU to the owner during the taxable year translated

into the owner's functional currency as provided in paragraph (d)(2)(ii) of this section. Because no such amounts were transferred, there is no change in the $1,416.67 determined in step 1.

(v) *Step 3.* Under paragraph (d)(3) of this section, the aggregate amount determined in paragraphs (d)(1) and (d)(2) of this section (steps 1 and 2) is decreased by the total amount of assets transferred from the owner to the section 987 QBU during the taxable year as determined in paragraph (d)(3)(ii) of this section in dollars. On July 1, 2021, U.S. Corp transferred to Japan Branch $1,000.00 (which Japan Branch immediately converted into ¥100,000) and raw land with a basis of $500.00 (equal to ¥55,000, translated under §1.987–2(d)(2) at the historic rate of $1 = ¥110). Thus, the $1,416.67 determined under steps 1 and 2 is reduced by $1,500.00, resulting in ($83.33).

(vi) *Steps 4 and 5.* Because no liabilities were transferred by U.S. Corp to Japan Branch or by Japan Branch to U.S. Corp during the taxable year, the aggregate amount determined in paragraph (d)(3) of this section (Step 3) is not increased or decreased.

(vii) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined after applying paragraphs (d)(1) through (5) of this section (steps 1 through 5) is decreased by the section 987 taxable income of Japan Branch of $90.91 from ($83.33) to ($174.24).

(viii) *Steps 7 and 8.* Paragraphs (d)(7) and (d)(8) do not apply because Japan Branch does not have any tax-exempt or nondeductible items. Accordingly, the unrecognized section 987 loss of Japan Branch for 2021 is ($174.24), the amount determined after applying step 6.

Example 2. (i) U.S. Corp operates in the United Kingdom through U.K. Branch, a section 987 QBU of U.S. Corp that has the pound as its functional currency. U.S. Corp properly elects under §1.987–1(c)(1)(ii) for U.K. Branch to use a spot rate convention (when permitted). Under the chosen convention, the spot rate (the ''convention rate'') for any transaction occurring during a month is the average of the pound spot rate and the 30-day forward rate for pounds on the next-to-last Thursday of the preceding month. The yearly average exchange rate was £1 = $0.90 for 2020, £1 = $1.00 for 2021, and £1 = $1.10 for 2022. The closing balance sheet of U.K. Branch in 2021 reflected the following assets:

(A) £100;

(B) A sales office purchased in 2020 with an adjusted basis of £1,000;

(C) A delivery truck purchased in 2020 with an adjusted basis of £200;

(D) Inventory of 100 units purchased in 2021 with a basis of £100; and

(E) Stock in ABC Corporation purchased in 2021 with a basis of £150, representing less than 10 percent of the total voting power and value of all classes of stock of ABC Corporation.

The closing balance sheet of U.K. Branch for 2021 reflected one liability, £50 of long-term debt entered into in 2020 with F Bank, an unrelated bank.

The office, truck, stock, and inventory are historic assets (as defined in §1.987–1(e)). The £100 and long-term debt are marked items (as defined in §1.987–1(d)). Assume that U.S. Corp translated U.K. Branch's 2021 closing balance sheet as follows:

Assets	Amount in £	Translation rate	Amount in $
Pounds	100.00	£1 = $1.05 (convention rate—Dec. 2021)	105.00
Office	1,000.00	£1 = $0.90 (historic rate—2020)	900.00
Truck	200.00	£1 = $0.90 (historic rate—2020)	180.00
Stock	50.00	£1 = $1.00 (historic rate—2021)	150.00
Inventory	100.00	£1 = $1.00 (historic rate—2021)	100.00
Total assets			1,435.00
Liabilities:			
Bank Loan	50.00	£1 = $1.05 (convention rate—Dec. 2021)	52.50
Total liabilities			52.50
2021 ending OFCNV			1,382.50

(ii) U.K. Branch uses the first-in, first-out (FIFO) method of accounting for inventory. In 2022, U.K. Branch sold 100 units of inventory for a total of £300 and purchased another 100 units of inventory for £100. There is depreciation of £33 with respect to the office and £40 with respect to the truck, and U.K. Branch incurred £30 of business expenses during 2022. Neither the depreciation nor the business expenses are inventoriable costs. All items of income earned and expenses incurred during 2022 are received and paid, respectively, in pounds. Under §1.987–3, U.K. Branch's section 987 taxable income or loss is determined as follows:

Item	Amount in £	Translation rate	Amount in $
Gross receipts	300.00	£1 = $1.10 (yearly average rate—2022)	330.00
Less:			
COGS	(100.00)	£1 = $1.00 (historic rate—2021)	(100.00)
Gross income			230.00
Dep:			
Office	(33.00)	£1 = $0.90 (historic rate—2020)	(29.70)
Truck	(40.00)	£1 = $0.90 (historic rate—2020)	(36.00)
Other expenses	(30.00)	£1 = $1.10 (yearly average rate—2022)	(33.00)
Total expenses			(98.70)
Section 987 taxable income			131.30

Accordingly, U.K. Branch has $131.30 of section 987 taxable income in 2022.

(iii) In December 2022, U.K. Branch transferred £30 to U.S. Corp, and U.S. Corp transferred a computer with a basis of $10 to U.K. Branch. U.S. Corp's net accumulated unrecognized section 987 gain or loss for all prior taxable years as determined in paragraph (c) of this section is $30.

(iv) The unrecognized section 987 gain or loss of U.K. Branch for 2022 is determined as follows:

(A) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of U.K. Branch determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of U.K. Branch determined on the last day of 2021. The OFCNV of U.K. Branch on December 31, 2022, and the change in OFCNV for 2022, are determined as follows:

Assets	Amount in £	Translation rate	Amount in $
Pounds	240.00	£1 = $1.15 (convention rate—Dec. 2022)	276.00
Office	967.00	1 = $0.90 (historic rate—2020)	870.30
Truck	160.00	£1 = $0.90 (historic rate—2020)	144.00
Inventory	100.00	£1 = $1.10 (historic rate—2022)	110.00
Computer	9.09	£1 = $1.10 (historic rate—2022)	10.00
Stock	150.00	£1 = $1.00 (historic rate—2021)	150.00
Total assets			1,560.30
Liabilities:			
Bank Loan	50.00	£1 = $1.15 (convention rate—Dec. 2022)	57.50
Total liabilities			57.50
2022 ending OFCNV			1,502.80
Less:			
2021 ending OFCNV			(1,382.50)
Change in OFCNV			120.30

(B) *Step 2.* Under paragraph (d)(2) of this section, the aggregate amount determined in step 1 must be increased by the total amount of assets described in paragraph (d)(2)(ii) of this section transferred from U.K. Branch to U.S. Corp during the taxable year, translated into U.S. Corp's functional currency as provided in paragraph (d)(2)(ii) of this section. The amount of assets transferred from U.K. Branch to U.S. Corp during 2022 is determined as follows:

Asset	Amount in £	Translation rate	Amount in $
£30	30.00	£1 = $1.15 (convention rate—Dec. 2022)	34.50

(C) *Step 3: Decrease the aggregate amount described in steps 1 and 2 by the owner's transfers to the section 987 QBU.* Under paragraph (d)(3) of this section, the aggregate amount determined in steps 1 and 2 must be decreased by the total amount of all assets transferred from U.S. Corp to U.K. Branch during the taxable year as determined in paragraph (d)(3)(ii) of this section. The amount of assets transferred from U.S. Corp to U.K. Branch during 2022 is determined as follows:

Asset			Amount in $
Computer			10.00

(D) *Step 4.* Under paragraph (d)(4) of this section, the aggregate amount determined in steps 1 through 3 must be decreased by the aggregate amount of liabilities transferred by U.K. Branch to U.S. Corp. Under these facts, such amount is $0.

(E) *Step 5.* Under paragraph (d)(5) of this section, the aggregate amount determined in steps 1 through 4 must be increased by the aggregate amount of liabilities transferred by U.S. Corp to U.K. Branch. Under these facts, such amount is $0.

(F) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 is decreased or increased, respectively, by any section 987 taxable income or loss of U.K. Branch computed under §1.987–3 for the taxable year. The amount of U.K. Branch's taxable income, as determined above, is $131.30.

(G) [Reserved]

(H) *Steps 7 and 8:* Paragraphs (d)(7) and (d)(8) do not apply because U.K. Branch does not have any tax-exempt income or nondeductible expense.

(v) *Summary.* Taking steps 1 through 8 into account, the amount of U.S. Corp's unrecognized section 987 gain or loss with respect to U.K. Branch in 2022 is computed as follows:

Step	Amount in $	Balance
1	+ 120.30	$120.30
2	+ 34.50	154.80
3	− 10.00	144.80
4	− 0	144.80
5	+ 0	144.80
6	− 131.30	13.50
7	+ 0	13.50
8	− 0	13.50

Thus, U.S. Corp's unrecognized section 987 gain for 2022 with respect to U.K. Branch is $13.50. As of the end of 2022, before taking into account the recognition of any section 987 gain or loss under §1.987–5, U.S. Corp's net unrecognized section 987 gain is $43.50 (that is, $30.00 accumulated from prior years, plus $13.50 in 2022).

Example 3. (i) *Background.* U.S. Corp is the owner of Business A, a section 987 QBU that has the euro as its functional currency. Business A uses the FIFO method to account for inventory and uses the simplified inventory method described in §1.987–3(c)(2)(iv)(A). On the last day of 2020, U.S. Corp begins Business A by contributing to Business A a building with a basis of $780, a machine with a basis of $300, and $100. On January 1, 2021, Business A converts the $100 into €100. The tax basis of the building and machine is translated into euros using the historic rate, which is the yearly average exchange rate for 2020, the year of the transfer. Accordingly, the building and the machine have a tax basis of €780 and €300, respectively, on December 31, 2020. The building and machine have annual depreciation of €20 and €30, respectively. Business A determines that 50 percent of the building depreciation should be allocated to the cost of goods manufactured (that is, treated as an inventoriable cost) and 50 percent should be allocated to selling, general and administrative (SG&A) expenses. The machine is used exclusively to manufacture inventory. Relevant exchange rates for purposes of this example are as follows:

Year	Yearly average exchange rate	December 31 spot rate
2020	€1 = $1.00	€1 = $1.00
2021	€1 = $1.50	€1 = $2.00
2022	€1 = $2.50	€1 = $3.00

(ii) *Operations in 2021.* During 2021, Business A recognizes €140 of revenue from sales of finished goods. The related COGS is €70. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2021 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2021, shows no liabilities and the following assets: currency of €160, the building with an adjusted basis of €760, the machine with an adjusted basis of €270, and ending inventory with a FIFO cost basis of €40, comprising raw materials and finished goods.

(A) *Determination of income.* Under the simplified inventory method, Business A's income for 2021 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	140	€1 = $1.50 (yearly avg. rate—2021)	210
COGS before adjustments	70	€1 = $1.50 (yearly avg. rate—2021)	105
Adjustment for cost recovery deductions (see calculation below).			(20)
Adjustment for beginning inventory (none).			0
Adjusted COGS			85

Item	Amount in €	Translation rate	Amount in $
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $1.50 (yearly avg. rate—2021)	15
Total SG&A			25
Section 987 net income (revenue less COGS and SG&A).			100

COGS Adjustments.

Adjustment for cost recovery deductions included in inventoriable costs.

Depreciation amount	Historic rate	2021 yearly avg. rate	Difference in translation rates	Adjustment (depreciation × change in rates)
€10 (building)	1.00	1.50	(0.50)	($5)
€30 (machine)	1.00	1.50	(0.50)	(15)
Total adjustment for cost recovery deductions				(20)

(B) *Determination of OFCNV for 2020 and 2021.*

Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2021

Assets	Amount in €	Translation rate	Amount in $
Euros	160	€1 = $2.00 (year-end spot rate—2021)	320
Building	760	€1 = $1.00 (historic rate—2020)	760
Machine	270	€1 = $1.00 (historic rate—2020)	270
Inventory	40	€1 = $1.50 (yearly average rate—2021)	60
Total assets			1,410
Liabilities:			
Total liabilities			0
2021 ending OFCNV			1,410

OFCNV—END OF 2020

Assets	Amount in €	Translation rate	Amount in $
Euros	100	€1 = $1.00 (year-end spot rate—2020)	100
Building	780	€1 = $1.00 (historic rate—2020)	780
Machine	300	€1 = $1.00 (historic rate—2020)	300
Total assets			1,180
Liabilities:			
Total liabilities			0
2020 ending OFCNV			1,180

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain or loss of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	$1,410
Less: 2020 ending OFCNV	(1,180)
Change in OFCNV	230

(*2*) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the

section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is $100.

Change in OFCNV	$230
Less: section 987 taxable income	(100)
Unrecognized section 987 gain	130
Plus: Net accumulated unrecognized section 987 gain or loss from prior years	0
Net unrecognized section 987 gain	130

(iii) *Operations in 2022.* During 2022, Business A recognizes €180 of revenue from sales of finished goods. The related COGS is €96. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2022 include €30 of depreciation on the machine and €10 of depreciation on the building. Business A's balance sheet on December 31, 2022, shows no liabilities and the following assets: currency of €260, the building with an adjusted basis of €740, the machine with an adjusted basis of €240, and ending inventory with a FIFO cost basis of €54, comprising raw materials and finished goods.

(A) *Determination of income.* Under the simplified inventory method, Business A's income for 2022 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	180	€1 = $2.50 (yearly avg. rate—2022)	450
COGS before adjustments	96	€1 = $2.50 (yearly avg. rate—2022)	240
Adjustment for cost recovery deductions (see calculation below).			(60)
Adjustment for beginning inventory (see calculation below).			(40)
Adjusted COGS			140
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $2.50 (yearly avg. rate—2022)	25
Total SG&A			35
Section 987 net income (revenue less COGS and SG&A).			275

COGS Adjustments.

Adjustment for cost recovery deductions.

Depreciation amount	Historic rate	2022 yearly avg. rate	Difference in translation rates	Adjustment (depreciation × change in rates)
€10 (building)	1.00	2.50	(1.50)	($15)
€30 (machine)	1.00	2.50	(1.50)	(45)
Total adjustment for cost recovery deductions				(60)

Adjustment for beginning inventory.

Prior year ending inventory	2021 yearly avg. rate	2022 yearly avg. rate	Difference in translation rates	Adjustment (inventory × change in rates)
€40	1.50	2.50	(1.00)	($40)
Total adjustment for beginning inventory				(40)

(B) *Determination of OFCNV.* Under the simplified inventory method, the OFCNV of Business A for 2022 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2022

Assets	Amount in €	Translation rate	Amount in $
Euros	260	€1 = $3.00 (year-end spot rate—2022)	780
Building	740	€1 = $1.00 (historic rate—2020)	740
Machine	240	€1 = $1.00 (historic rate—2020)	240
Inventory	54	€1 = $2.50 (yearly average rate—2022)	135
Total assets			1,895
Liabilities:			
Total liabilities			0
2022 ending OFCNV			1,895

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	$1,895
Less: 2021 ending OFCNV	(1,410)
Change in OFCNV	485

(*2*) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is $275.

Change in OFCNV	$485
Less: Section 987 taxable income	(275)
Unrecognized section 987 gain 2022	210
Plus: Net accumulated unrecognized section 987 gain from prior year	130
Net unrecognized section 987 gain	340

Example 4. (i) *Background.* The background facts about Business A are the same as in *Example 3*, except that Business A uses the dollar-value LIFO method to account for inventory.

(ii) *Operations in 2021.* The facts about Business A's operations in 2021 are the same as in *Example 3*.

(A) *Determination of income.* Under the simplified inventory method, Business A's income for 2021 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	140	€1 = $1.50 (yearly avg. rate—2021)	210
COGS before adjustments	70	€1 = $1.50 (yearly avg. rate—2021)	105
Adjustment for cost recovery deductions (same as *Example 1*).			(20)
Adjustment for LIFO liquidation (none).			0
Adjusted COGS			85
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $1.50 (yearly avg. rate—2021)	15
Total SG&A			25
Section 987 net income (revenue less COGS and SG&A).			100

(B) *Determination of OFCNV for 2020 and 2021.* Under the simplified inventory method, the OFCNV of Business A for 2020 and 2021 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2021

Assets	Amount in €	Translation rate	Amount in $
Euros	160	€1 = $2.00 (year-end spot rate—2021)	320
Building	760	€1 = $1.00 (historic rate—2020)	760

OFCNV—END OF 2021—Continued

Assets	Amount in €	Translation rate	Amount in $
Machine	270	€1 = $1.00 (historic rate—2020)	270
Inventory	40	€1 = $1.50 (historic rate—2021)	60
Total assets			1,410
Liabilities:			
Total liabilities			0
2021 ending OFCNV			1,410

OFCNV—END OF 2020

Assets	Amount in €	Translation rate	Amount in $
Euros	100	€1 = $1.00 (year-end spot rate—2020)	100
Building	780	€1 = $1.00 (historic rate—2020)	780
Machine	300	€1 = $1.00 (historic rate—2020)	300
Total assets			1,180
Liabilities:			
Total liabilities			0
2020 ending OFCNV			1,180

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain or loss of Business A for 2021 is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2021, less the OFCNV of Business A determined on the last day of 2020.

2021 ending OFCNV	$1,410
Less: 2020 ending OFCNV	(1,180)
Change in OFCNV	(230)

(*2*) *Step 6.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2021, as determined above, is $100.

Change in OFCNV	$230
Less: section 987 taxable income	(100)
Unrecognized section 987 gain	130
Plus: Net accumulated unrecognized section 987 gain or loss from prior years	0
Net unrecognized section 987 gain	130

(iii) *Operations in 2022.* The facts about Business A's operations in 2022 are the same as in *Example 3*, except that due to Business A's dollar-value LIFO method of inventory accounting, Business A's balance sheet on December 31, 2022, reflects a 2021 layer of inventory with a LIFO cost basis of €40 and a 2022 layer of inventory with a LIFO cost basis of €10.80, and Business A's COGS is €99.20.

(A) *Determination of income.* Business A's income for 2022 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	180	€1 = $2.50 (yearly avg. rate—2022)	450
COGS before adjustments	99.20	€1 = $2.50 (yearly avg. rate—2022)	248
Adjustment for cost recovery deductions (same as *Example 3*).			(60)
Adjustment for LIFO liquidation (none).			0
Adjusted COGS			188
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $2.50 (yearly avg. rate—2022)	25
Total SG&A			35
Section 987 net income (revenue less COGS and SG&A).			227

OFCNV—END OF 2022

Assets	Amount in €	Translation rate	Amount in $
Euros	260.00	€1 = $3.00 (year-end spot rate—2022)	780
Building	740.00	€1 = $1.00 (historic rate—2020)	740
Machine	240.00	€1 = $1.00 (historic rate—2020)	240
Inventory	10.80	€1 = $2.50 (historic rate—2022)	27
	40.00	€1 = $1.50 (historic rate—2021)	60
Total assets			1,847
Liabilities:			
Total liabilities			0
2022 ending OFCNV			1,847

(B) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain of Business A for 2022 is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2022, less the OFCNV of Business A determined on the last day of 2021.

2022 ending OFCNV	$1,847
Less: 2021 ending OFCNV	(1,410)
Change in OFCNV	437

(*2*) *Step 6—Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2022, as determined above, is $227.

Change in OFCNV	$437
Less: section 987 taxable income	(227)
Unrecognized section 987 gain 2022	210
Plus: net accumulated unrecognized section 987 gain from prior years	130
Net unrecognized section 987 gain	340

(iv) *Operations in 2023.* During 2023, Business A recognizes revenue of €252 from sales of finished goods. The related COGS is €140.80, reflecting a full liquidation of the 2022 inventory layer with a LIFO cost basis of $10.80 and a partial liquidation of inventory from the 2021 layer with a LIFO cost basis of $10.00. Business A pays €10 in salaries allocable to SG&A. Inventoriable costs in 2023 include €10 of depreciation on the building and €30 of depreciation on the machine. Business A's balance sheet on December 31, 2023, shows no liabilities and the following assets: currency of €422, the building with an adjusted basis of €720, the machine with an adjusted basis of €210, and a 2021 layer of ending inventory with a LIFO cost basis of €30, comprising raw materials and finished goods. The yearly average exchange rate for 2023 is €1 = $3.50, and the spot rate on December 31, 2023 is €1 = $4.00.

(A) *Determination of income.* Business A's income for 2023 is computed as follows:

Item	Amount in €	Translation rate	Amount in $
Sales revenue	252	€1 = $3.50 (yearly avg. rate—2023)	882
COGS before adjustments	140.80	€1 = $3.50 (yearly avg. rate—2023)	492.80
Adjustment for cost recovery deductions (see calculation below).			(100.00)
Adjustment for LIFO liquidation (see calculation below).			(30.80)
Adjusted COGS			362.00
SG&A:			
Depreciation on building (50%)	10	€1 = $1.00 (historic rate—2020)	10
Salaries	10	€1 = $3.50 (yearly avg. rate—2023)	35
Total SG&A			45
Section 987 net income			475

COGS Adjustments.
Adjustment for cost recovery deductions.

Depreciation amount	Historic rate	2023 yearly avg. rate	Difference in translation rates	Adjustment (depreciation × change in rates)
€10 (building)	1.00	3.50	(2.50)	($25)
€30 (machine)	1.00	3.50	(2.50)	(75)
Total adjustment for cost recovery deductions				(100)

Adjustment for LIFO liquidation.

LIFO liquidation layer	Historic rate	2023 yearly avg. rate	Difference in translation rates	Adjustment (liquidated layer × change in rates)
€10.80 (2022)	2.50	3.50	(1.00)	($10.80)
€10 (2021)	1.50	3.50	(2.00)	(20.00)
Total adjustment for liquidation of LIFO layers				(30.80)

(B) *Determination of OFCNV.* The OFCNV of Business A for 2023 is determined under paragraph (e) of this section as follows:

OFCNV—END OF 2023

Assets	Amount in €	Translation rate	Amount in $
Euros	422	€1 = $4.00 (year-end spot rate—2023)	1,688
Building	720	€1 = $1.00 (historic rate—2020)	720
Machine	210	€1 = $1.00 (historic rate—2020)	210
Inventory	30	€1 = $1.50 (historic rate—2021)	45
Total assets			2,663
Liabilities:			
Total liabilities			0
2023 ending OFCNV			2,663

(C) *Determination of net unrecognized section 987 gain or loss.* The net unrecognized section 987 gain of Business A is determined under paragraph (d) of this section as follows (relevant steps only):

(*1*) *Step 1.* Under paragraph (d)(1) of this section, the change in OFCNV for the taxable year must be determined. This amount is equal to the OFCNV of Business A determined under paragraph (e) of this section on the last day of 2023, less the OFCNV of Business A determined on the last day of 2022.

2023 ending OFCNV	$2,663
Less: 2022 ending OFCNV	(1,847)
Change in OFCNV	816

(*2*) *Step 6—Decrease the aggregate amount determined in steps 1 through 5 by the section 987 taxable income of the section 987 QBU for the taxable year.* Under paragraph (d)(6) of this section, the aggregate amount determined in steps 1 through 5 must be decreased by the section 987 taxable income of Business A. The amount of Business A's taxable income for 2023, as determined above, is $475.

Change in OFCNV	$816
Less: section 987 taxable income	(475)
Unrecognized section 987 gain 2023	341
Plus: net accumulated unrecognized section 987 gain from prior years	340
Net unrecognized section 987 gain	681

[T.D. 9794, 81 FR 88821, Dec. 8, 2016, as amended by T.D. 9795, 81 FR 88873, Dec. 8, 2016]