February 12, 2024

U.S. Department of the Treasury
1500 Pennsylvania Ave NW
Washington, D.C. 20220

Re: 2023 Proposed Regulations for Determining Income and Currency Gain or Loss with Respect to a Qualified Business Unit

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit comments on the 2023 proposed section 987 regulations[2] addressing the determination of income and currency gain or loss with respect to a qualified business unit.

These proposed regulations are particularly important for SIFMA members given their business models, the long and complicated history of the government's efforts to implement section 987 since the Tax Reform Act of 1986, the various efforts to provide guidance, and the industry's history of relying on these different sets of proposed regulations, in particular the 1991 Proposed Regulations.[3] It is with this context that SIFMA provides these comments to this latest set of proposed regulations and looks forward to continuing to work with the Treasury Department and the IRS to further refine the implementation of section 987 in a manner that is most relevant to our industry.

I. Executive Summary

As discussed in more detail in Section III, and to address the concerns raised in the 2023 proposed regulations, SIFMA makes the following recommendations:

- Section III.A: We recommend implementing a section 987 hedging election that operates in a similar fashion to a Treas. Reg. § 1.954-2(g)(3) election to cure mismatches arising from bona fide

1 SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

2 REG-132422-17, November 9, 2023 (the "2023 proposed regulations").

3 56 FR 48457, September 25, 1991 (the "1991 proposed regulations").

hedging activity. Specifically, if a taxpayer makes the proposed section 987 hedging election, then taxable items arising from bona fide hedging transactions hedging foreign currency exposure associated with section 987 QBUs are treated as the same source and separate limitation category as the associated section 987 gains and losses would be assigned under Treas. Reg. § 1.987-6.

- Section III.B: Revise Prop. Reg. § 1.987-6 such that (i) section 987 gains and losses initially assigned to a tentative tested income group are *included* in the calculation of the GILTI HTE ETR and (ii) section 987 gains and losses that are associated with highly taxed tested units are *excluded* from the computation of tested income pursuant to Treas. Reg. §1.951A-2(c)(7).

- Section III.C: Include a de minimis exception for the loss-to-the-extent-of-gain rule ("loss suspension rule") under the current rate election based on a percentage of historic assets held by the taxpayer as compared to total assets (i.e., historic and marked assets). More specifically, if historic assets represent less than [5%] of a taxpayer's balance sheet, the loss suspension rule would not apply to such taxpayer's section 987 losses.

- Section III.D: For purposes of determining recognized section 987 gains and losses under Prop. Reg. §§ 1.987-5(c) and (d), include a carve-out / exemption from the recharacterization rules described in Treas. Reg. § 1.987-2(c)(2) for certain recurring interbranch and intercompany funding transactions undertaken by regulated global financial institutions. We would recommend leveraging both the funding rule described in Treas. Reg. § 1.385-3(b)(3)(vii)(A) and the regulated financial company exception described in Treas. Reg. § 1.385-3(g)(3)(iv).

- Section III.E: Clarify that applying the "earnings only" method or "earnings and capital" method, with modifications to make such methods administrable, is "any other reasonable" manner of applying such methods and would therefore qualify as an eligible pretransition method under Prop. Reg. § 1.987-10.

II. Background

A. Overview of Foreign Branch Network in the Financial Services Industry

For both business and regulatory reasons, US-based global banks operate in true branch form outside of the United States ("U.S."). As banks have allocated billions of U.S. dollars ("USD") of capital to their foreign branch networks, the proposed section 987 regulations are of keen interest to SIFMA members.

A global branch network enables banks to meet the expectations of their global customers for global banking services provided through a single counterparty. Customers generally prefer the relative simplicity of contracting with the licensed branches of a global bank rather than facing separately incorporated subsidiaries in each country. For example, a customer who deposits funds in a bank's New York branch and enters into a swap with its London branch has a relationship with a single legal entity. Banks generally prefer to do business in branch form because it facilitates the free flow of funding and liquidity amongst branches allowing banks to move funding to where it is needed faster than it otherwise could if operating in corporate form. Continuing the example, to the extent the London branch has a funding need in connection with the swap, the bank can leverage excess liquidity in its New York branch (or another branch) to quickly meet its funding need. A direct consequence of this funding arrangement is that banks typically have a high volume of short-term interbranch placements, deposits and similar instruments among their head office and regulated foreign branches. As many foreign branches of US-based global banks have a non-functional currency other than the USD, the proposed 2023 regulations are of great importance to the industry.

B. Historical Approach to Section 987 – Financial Services Industry

Section 987 has a long and complicated history which has continued to evolve since the Tax Reform Act of 1986. SIFMA acknowledges that the Department of the Treasury ("Treasury") has released several sets of proposed, temporary, and final regulations throughout the 1990s and early 2000s with an aim to simplify the complexities of determining taxable income or loss and foreign currency gains and losses with respect to QBUs which have a different functional currency than its controlled foreign corporation ("CFC") or US owner ("tax owner").

Despite the many proposed simplifications to the rules since 1986, the overwhelming majority of global financial institutions have continued to follow the 1991 proposed regulations which require taxpayers to calculate income or loss in the QBU's functional currency, to be later translated into the tax owner's functional currency at the average exchange rate for the taxable year. Under the 1991 proposed regulations, section 987 gains and losses are recognized in a tax owner's taxable income when a QBU makes or is deemed to make a remittance to its tax owner.

The Foreign Exchange Exposure Pool ("FEEP") method which was introduced in connection with the release of the 2006 proposed regulations[4] and later modified in the 2016 final regulations,[5] generally requires an owner of a section 987 QBU to account for foreign currency gains and losses based on changes in a QBU's balance sheet (marked assets are translated at the spot rate and historic assets are translated at historic rates).

Given that banks typically hold balance sheets which consist primarily of marked assets, applying the FEEP method (which requires a taxpayer to apply different foreign exchange rates depending on whether an asset is a marked or historical asset) was generally viewed by banks as administratively burdensome relative to the proposed 1991 regulations without producing a materially different result. This view was also acknowledged by Treasury in each future set of section 987 regulations produced following the proposed 1991 regulations and up to the 2023 proposed regulations, which allowed banks and certain financial institutions to continue to follow the proposed 1991 regulations.

III. Detailed Comments

A. *<u>We recommend consideration be given to a section 987 hedging election whereby a taxpayer could identify a bona fide hedging transaction, relying upon the "bona fide hedging transaction" concept and identification rules in Treas. Reg. § 1.954-2 and section 1221, hedging section 987 exposures.</u>*

As discussed above, many global financial institutions headquartered in the U.S. operate in foreign countries via branches. Given that these branches often operate in a functional currency other than the USD, such firms must account for the application of section 987 to their foreign operations.

The assumption of currency risk is an ordinary and necessary part of operating a U.S.-based global banking business. In order to mitigate the economic exposure of such firm's net investment in branches and subsidiaries whose functional currency is something other than the USD, such firms often enter into hedging arrangements with third parties. Given the size of such firm's exposure to multiple non-USD currencies, the market-facing location in which hedges are booked is often centralized either in the U.S. or regionally. To the extent a hedge is booked in a location other than the direct parent of the legal entity or section 987 QBU where the underlying FX exposure resides ("At-Risk Parent"), the economics of the market-facing hedge is often moved from the booking location to the At-Risk Parent via a back-to-back trade mirroring the trade the booking location entered into in the market. These back-to-back arrangements exist primarily to (1) qualify these hedges for FAS 133 treatment under US GAAP and (2) to avoid "split hedges", i.e., instances where the hedge and hedged item are located in different locations for book, tax, and/or regulatory purposes. Such hedges generally qualify as hedges for tax purposes under section 1221. Such hedging activity, as is customary with most hedging activity, is usually performed on an aggregate hedging basis whereby the taxpayer aggregates risks associated with various transactions and assets. Notwithstanding such hedging

[4] 71 FR 52876, September 7, 2006 (the "2006 proposed regulations"),

[5] 71 TD 9794, December 8, 2016 (the "2016 proposed regulations"),

activities, companies often suffer from effective tax rate ("ETR") volatility arising from fluctuations in foreign currency values. This volatility arises due to differences in how taxable items arising from hedging activities are sourced and categorized under section 904, compared to how taxable items from the hedged assets arising from the application of section 987 are sourced and categorized.

As the examples below illustrate, in the case of a section 987 QBU owned directly by a domestic corporation, the asymmetry in treatment of taxable items arising from hedging activities versus the treatment of taxable items arising from the hedged assets can result in sourcing and income category mismatches. These mismatches can have a significant impact on a domestic corporation's foreign tax credit ("FTC") limitation. For example, if a domestic corporation recognizes a section 987 loss in relation to a foreign branch, such loss will generally be assigned to the foreign source foreign branch category. However, based on common practice in the banking world, as described above, of centrally hedging out of the U.S. head office either directly or through back-to-back arrangements with overseas branches, the associated hedging gain will generally be either domestic source general basket or foreign source general basket income. As a result of the asymmetry, the domestic corporation's ability to claim FTCs on taxes paid by the foreign branch will be reduced.

Examples

Example 1 – FX Hedging Out of US Head Office

Facts: On January 1, Year 1, DC, a domestic corporation with a calendar year taxable year, establishes Business A operations in Country A ("Country A Branch"). The national currency of Country A is the A$. DC invests A$1,000 in Country A Branch when the A$/USD exchange rate was 1:1. Country A Branch is a section 987 QBU with the A$ currency as its functional currency. Country A Branch's Business A generates foreign source foreign branch category gross income. DC hedges its investment in Country A Branch with rolling forward contracts with a third party. During Year 1, the A$/USD exchange rate changes to 1.2:1 as of December 31, Year 1. The average A$/USD exchange rate for Year 1 was 1.1:1. Country A Branch earned A$100 during Year 1. Assume all Country A Branch assets are marked assets and generate foreign source foreign branch category gross income.

Treas. Reg. § 1.987-4(d) Steps	Amount in A$	Translation Rate	Amount in USD
Step 1: Country A Branch assets	A$1,100	1.2:1 A$/USD (spot rate, 12/31/Y1)	$916.67
Step 2: No adjustment			
Step 3 adjustment	(A$1,000)	1:1 A$/USD (spot rate, 1/1/Y1)	($1,000.00)
Step 4: No adjustment			
Step 5: No adjustment			
Step 6 adjustment	(A$100)	1.1:1 A$/USD (average rate, Y1)	($90.91)
Step 7: No adjustment			
Step 8: No adjustment			
Step 9: No adjustment			
Step 10: No adjustment			
Step 11: No adjustment			

Section 987 gain/(loss)			($174.24)

Country A Branch Section 987 Loss: Pursuant to Treas. Reg. § 1.987-6(b) and Prop. Reg. § 1.987-6(b)(2)(i), to the extent DC recognizes some or all of the $174.84 section 987 loss associated with its investment in Country A Branch, such loss is assigned to the foreign source foreign branch category.

DC's Hedging Gains: Assuming DC has a gain in relation to its hedging activities equivalent to the Country A Branch section 987 loss, DC recognizes a $174.24 gain assigned to the domestic source general category pursuant to section 988(a)(3)(A) and Treas. Reg. § 1.988-4(a).

DC's Foreign Tax Credit Limitation: As a result of the asymmetry between the treatment of DC's section 987 loss and its hedging activities results, DC suffers double taxation as a result of being unable to credit any income taxes paid to Country A in relation to Country A Branch's activities.

Example 2 – FX Hedging out of Foreign Branch

Facts: Same facts as Example 1 except DC also operates Business B operations in Country B ("Country B Branch"). Country B Branch's functional currency is the US dollar. Rather than DC facing a third party directly in relation to it's a$/USD forward contract, DC enters into an A$/USD forward contract with Country B Branch (DC is short A$) and Country B Branch faces a third party on a similar A$/USD forward contract (Country B Branch is short A$).

Country A Branch Section 987 Loss: Pursuant to Treas. Reg. § 1.987-6(b) and Prop. Reg. § 1.987-6(b)(2)(i), to the extent DC recognizes some or all of the $174.84 section 987 loss associated with its investment in Country A Branch, such loss is assigned to the foreign source foreign branch category.

DC/Country B Branch's Hedging Gains: Country B Branch receives a $174.24 taxable gain as a result of its A$/USD forward contract transactions with a third party. That gross income is initially assigned to the foreign source foreign branch category. That same amount is settled with DC under the intracompany A$/USD forward contract between DC and Country B Branch. Pursuant to the disregarded reattribution transaction rules of Treas. Reg. § 1.904-4(f)(2)(vi), such gain is reattributed from Country B Branch to DC and reassigned from the foreign source foreign branch category to the foreign source general category.

DC's Foreign Tax Credit Limitation: As a result of the asymmetry between the treatment of DC's section 987 loss and its hedging activities results, DC suffers double taxation as a result of being unable to credit any income taxes paid to Country A in relation to Country A Branch's activities.

Summary Considerations:

The asymmetry of treatment between section 987 gains and losses and the taxable items arising from hedging transactions can lead to taxpayer's income tax liability not bearing a coherent relationship to their economic income. This distortion can provide a random windfall to taxpayers or to the government based on the direction of the USD relative to the currencies being hedged. More so, this distortion discourages taxpayers who otherwise would strongly consider making both the current rate election and annual recognition election from doing so.

A recurring theme in tax policy in the foreign currency area has been efforts to eliminate mismatches in the treatment of the taxable items arising from hedged assets and the treatment of the taxable items arising from the hedging transactions entered into in relation to such assets. Generally, the mismatches described above are mitigated by a rule that seeks to match the characterization of the taxable items arising from a hedging transaction with the characterization of the relevant taxable items arising from the hedged assets. Such a solution does not disturb the separate federal tax treatment of the hedging transactions and the hedged assets.

Alternatively, integration could be utilized whereby the hedging transactions and the hedged assets are integrated such that what is actually a long foreign currency position (the hedged asset) and what is actually a short foreign currency position (the hedging transaction) are integrated to create a synthetic USD position.

A section 987 hedging election would produce at least three benefits: First, such election would align the tax treatment of a taxpayer's exposure to foreign currencies with the underlying economics. Second, a taxpayer making the election would be encouraged to make the annual recognition and current rate elections, which, consistent with Treasury's intent, should greatly simplify such taxpayer's compliance and reporting obligations with respect to section 987. Finally, such election would facilitate the IRS's ability to audit section 987, something which has been historically challenging given the volume of (often historic) information required. Crucially, a section 987 hedging election would accomplish all of this without prejudicing the interests of either the government or taxpayers. On the other hand, allowing these mismatches to persist would expose taxpayers who have made an effort to protect themselves from foreign currency valuation fluctuations through hedging activities to continuing economic volatility driven by foreign currency valuation fluctuations.

<u>Example of Mismatch Solution</u>

Treas. Reg. § 1.954-2(g)(3) Election

As a general rule, the excess of foreign currency gains over foreign currency losses recognized by a CFC from section 988 transactions or property constitutes foreign personal holding company income ("FPHCI").[6] However, various exceptions apply to this general rule. Most notably, the excess of foreign currency gains over foreign currency losses recognized by a CFC in relation to section 988 transactions or property directly related to the business needs of the CFC do not constitute FPHCI (business needs exclusion). In addition to satisfying other requirements, a foreign currency gain or loss must arise from a transaction entered into, or property used, in the normal course of the CFC's business that does not give rise to subpart F income other than the foreign currency gain or loss itself.[7] The combination of the default rule treating foreign currency gains and losses are FPHCI and the availability of the business needs exclusion only to foreign currency gains and losses associated with business activities that do not give rise to subpart F income created the potential for mismatches similar to the section 987 examples described above.

Consider the following example:

CFC is a sales company that earns foreign base company sales income under section 954(d). CFC aggregates the currency risk on all of its transactions that generate foreign base company sales income and hedges this net exposure.

Because CFC's business activities give rise to subpart F income, the business needs exclusion is not applicable. Accordingly, any foreign currency gain or loss recognized by CFC in relation to its hedging activities would be assigned to the FPHCI subpart F category, usually passive category if the CFC is not a financial services entity, notwithstanding the CFC's business activities are giving rise to general category foreign base company sales income. This mismatch can create FTC complications. Additionally, the United States shareholder of CFC might be required to include CFC's foreign base company sales income without any reduction for losses associated with CFC's hedging activities.[8] As with the section 987 examples above, a mismatch between the treatment of the taxable items arising from the hedged assets or activities and the treatment of the taxable items arising from the associated hedging activities can result in a taxpayer tax liability not having a rational relationship to its economic experience.

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[6] Section 954(c)(1)(D).

[7] Treas. Reg. § 1.954-2(g)(2)(ii)(B)(1).

[8] Treas. Reg. § 1.951-1(c)(1)(ii).

To address the mismatch described above, Treas. Reg. § 1.954-2(g)(3) provides for an election whereby foreign currency gain or loss that is otherwise includible in the computation of FPHCI is excluded from FPHCI and instead assigned to the category or categories of subpart F income to which such gain or loss relates.[9] Generally, in order for the election to apply to assign foreign currency gain or loss to a specific subpart F category other than FPHCI, such gain or loss must arise from:

- A transaction, other than a hedging transaction, entered into, or property used or held for use, in the normal course of the CFC's trade or business that gives rise to income in such subpart F category; or

- A bona fide hedging transaction with respect to a transaction entered into or property used or held for use in the normal course of the CFC's trade or business that gives rise to income in such subpart F category.[10]

A "bona fide hedging transaction" is a transaction that meets the requirements of Treas. Reg. § 1.1221-2(a) through (d) except that when applying Treas. Reg. § 1.1221-2(b), transactions dealing with risk associated with section 1231 property or a section 988 transaction can be considered. Also, the taxpayer must comply with certain identification and recordkeeping requirements described in Treas. Reg. § 1.1221-2(f).

If the Treas. Reg. § 1.954-2(g)(3) election is made in the example above, then taxable items arising from hedging transactions entered into by CFC would be assigned to the foreign base company sales income category. As a result, the mismatch between the treatment of CFC's business operations and its hedging activities is eliminated.

SIFMA Recommendation

We recommend implementing a section 987 hedging election that operates in a similar fashion to a Treas. Reg. § 1.954-2(g)(3) election to cure mismatches arising from bona fide hedging activity. Specifically, if a taxpayer makes the proposed section 987 hedging election then taxable items arising from bona fide hedging transactions hedging foreign currency exposure associated with section 987 QBUs are treated as the same source and separate limitation category as the associated section 987 gains and losses would be assigned under Treas. Reg. § 1.987-6.[11] We think it may be sensible to limit the availability of the section 987 hedging election to taxpayers that have made the annual recognition election of Prop. Reg. § 1.987-5(a)(2), in order to ensure matched timing.

Revisiting Example 1, if DC had made the section 987 hedging election described above, then the taxable gain associated with the hedging transaction would be treated as a foreign source foreign branch category item effectively netting against the associated section 987 loss, which would be recognized currently assuming DC is required to have an active annual recognition election in order to make the section 987 hedging election. Accordingly, DC's foreign branch category FTC limitation calculation will likely yield a result more in line with policy expectations.

Example 2 highlights a mechanical issue that must be managed in the current tax landscape to ensure the mismatch fix is effective. In Example 2, the taxable gain recognized by DC's Country B Branch is initially assigned to the foreign source foreign branch category but is reattributed to DC and assigned to the foreign source general category after the application of the disregarded reattribution transaction rules. Accordingly,

9 Treas. Reg. § 1.954-2(g)(3)(i).

10 *Id.*

11 Alternatively, the election could impact the treatment of section 987 gains and losses rather than the taxable items arising from bona fide hedging transactions, i.e., rather than matching the taxable items arising from the hedging activity to the section 987 gains and losses of the section 987 QBU the election could impact the treatment the section 987 gains and losses to match them to the treatment of the taxable items arising from the hedging activity.

the proposed section 987 hedging election must allow for the modification of the treatment of taxable items from hedging transactions after other provisions have sought to assign it to a particular category. However, if the proposed section 987 hedging election is structured in such a manner, then, like Example 1, the assignment of the taxable items from the hedging activities would be to the foreign source foreign branch category and have the same normalizing effects as was seen with Example 1.

Revise Prop. Reg. § 1.987-6 such that (i) section 987 gains and losses are included in the GILTI HTE ETR and (ii) section 987 gains and losses that are associated with highly taxed tested units (i.e., as determined in connection with the GILTI HTE election) are excluded from the computation of tested income pursuant to Treas. Reg. §1.951A-2(c)(7).

SIFMA notes that pursuant to Prop. Reg. § 1.987-6, (i) section 987 gains and losses should be excluded from the initial GILTI HTE ETR computation, and (ii) section 987 gains and losses associated with highly taxed tested units are included in the computation of tested income.[12] As discussed below, we believe that the impact of Prop. Reg. § 1.987-6 on taxpayers making the GILTI HTE election will lead to overly harsh and inappropriate results.

Most notably, disallowing an exclusion for section 987 gains associated with highly taxed tested units from the computation of tested income could subject section 987 gains of a CFC to the GILTI regime with little or no ability to claim an associated FTC.[13] Additionally, including in tested income section 987 *losses* attributable to a highly tax tested unit could result in a taxpayer being in an unexpected overall tested loss position at the end of the year.

Further, this proposed methodology gives rise to a general inconsistency from other activities giving rise to foreign exchange gains and losses (both in the U.S. and CFC context). We feel it is unreasonable to treat section 987 gains and losses differently from other currency gains and losses such as hedging gains and losses, which are not assigned to a separate tentative tested income group and are excluded from tested income to the extent associated with a highly taxed tested unit.

Many US-based global banks hedge their section 987 exposure in CFC branches via financial instruments entered into by the head office of the CFC. Absent adoption of the hedging election described in IIIA, a section 987 gain associated with a 987 branch of a CFC would be fully taxed as GILTI whereas the associated hedging loss sitting in the CFC head office may not be if the CFC head office is highly taxed.

Lastly, including all section 987 gains and losses in tested income, especially with respect to taxpayers which apply the annual recognition election, would create volatility in a taxpayer's global ETR and it would be nearly impossible to project taxable income nor the ETR in a particular year due to the inability to plan for currency fluctuations.

SIFMA accepts the rationale behind excluding section 987 gains and losses that are not subject to local taxation from the GILTI HTE ETR calculations. However, including section 987 gains and losses associated with highly taxed QBUs as tested income has the potential to create unpredictable and inappropriate results.

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12 Pursuant to Treas. Reg. § 1.951A-2(c)(1)(iii), tested income excludes gross income that is highly taxed. Prop. Reg. § 1.987-6(b)(2)(i)(D)(2), if finalized in its current form, would operate to initially assign section 987 gains and losses of a CFC that relate to a section 987 tested unit of such CFC to a tentative tested income group consisting solely of such section 987 gains and losses. Section 987 gains and losses are therefore treated as its own tentative tested income item and are not excluded from tested income under Treas. Reg. §1.951A-2(c)(7).

13 See the preamble to the 2023 proposed regulations: "Because foreign countries generally do not impose tax on section 987 gain, allocation and apportionment of a foreign income tax to section 987 gain under Treas. Reg. § 1.861-20 and Prop. Reg. § 1.987-6(b)(3) will likely be uncommon. As a result, a tentative tested income item consisting of section 987 gain may often have a zero percent effective rate of foreign tax, and therefore, would generally not qualify for the GILTI high-tax exclusion."

SIFMA therefore recommends the following changes to Prop. Reg. § 1.987-6, considering the need for consistency: (i) section 987 gains and losses initially assigned to a tentative tested income group are *included* in the calculation of the GILTI HTE ETR and (ii) section 987 gains and losses that are associated with highly taxed tested units are *excluded* from the computation of tested income. As described above, including any tentative tested income item associated with a highly taxed tested unit would have severe results on a taxpayer (with no ability to forecast such inappropriate results).

SIFMA Recommendation:

- Revise Prop. Reg. § 1.987-6 such that (i) section 987 gains and losses initially assigned to a tentative tested income group are *included* in the calculation of the GILTI HTE ETR and (ii) section 987 gains and losses that are associated with highly taxed tested units are excluded from the computation of tested income.

B. Include a de minimis exception for the loss suspension rule under the current rate election based on a percentage of historic assets held by the taxpayer as compared to total assets (i.e., historic and marked assets). More specifically, if historic assets represent less than [5%] of a taxpayer's balance sheet, the loss suspension rule would not apply to such taxpayer's section 987 gains and losses.

Current Rate Election – Application to Financial Institutions

Typically, financial institutions have relatively small amounts of historic assets in their section 987 QBUs but significant amounts of marked assets. The current rate election made in connection with the annual recognition election should be desirable for most financial institutions which have historically applied the "earnings and capital" method under the 1991 proposed regulations as this would allow for a somewhat seamless transition in methodology for computing section 987 gains and losses.[14] Under the 1991 proposed regulations, income or loss is computed annually in the foreign branch's functional currency and is translated into the owner's functional currency at an average exchange rate for the year. Section 987 gains and losses are recognized when a foreign branch makes a remittance to its owner or upon a branch termination. However, when considering making the current rate election, financial institutions have to consider the potential application of the loss suspension rule introduced in the 2023 proposed regulations.

If a taxpayer does not make the current rate election or elects both the current rate election and annual recognition election, then such taxpayer can recognize section 987 losses in relation to marked assets without being limited by the loss suspension rule. Under the loss suspension rule, section 987 losses with respect to all assets of a section 987 foreign branch can only be recognized to the extent of current and future section 987 gains of the same character and recognized by the section 987 QBU owner. A consequence of making the current rate election is application of the loss suspension rule to all section 987 losses, regardless as to whether they relate to historic assets or marked assets. Notably, the current rate election does not directly impact the computation of section 987 gains and losses in relation to marked assets. The 2023 proposed regulations do not explicitly explain why section 987 losses related to marked assets can be recognized without limitation by the loss suspension rule if no current rate election is made but are so limited if such election is made. SIFMA's view is if a taxpayer makes the current rate election, then the loss suspension rule should only apply to section 987 gains and losses related to historic assets not all assets. We concede that limiting the scope of the loss suspension rule in this manner may require the maintenance of separate section 987 pools whereby one consists solely of historic assets and the other consists solely of marked assets.

It is SIFMA's view that limiting recognition of section 987 losses in relation to marked assets as a consequence of the current rate election makes it much less likely taxpayers will make the current rate election.

[14] A taxpayer that makes the current rate election may treat all assets and liabilities of a section 987 foreign branch as a marked item and therefore, taxable income or loss is translated at the yearly average exchange rate and further, all balance sheet items are translated at the year-end spot rate.

Summary Recommendation

SIFMA Recommendation:

- SIFMA recommends incorporating a de minimis exception which would be applicable to taxpayers holding minimal historic assets which would give rise to section 987 losses. The de minimis exception would turn off the loss suspension rule under the current rate election if a taxpayer's historic assets represent less than [5%] of a taxpayer's balance sheet. There are several examples in the Code and Regulations where a de minimis rule was justified based on the underlying policy.[15] The de minimis exception would be an annual test applied at the level of the section 987 QBU owner and computed by taking into account all section 987 QBUs owned by such owner. The de minimis exception could be applied on the basis of the values of assets utilized by the taxpayer to allocate and apportion interest expense under Treas. Reg. §1.861-9.

- In situations where the loss suspension rules apply (e.g., a taxpayer electing the current rate election), limit the scope of the loss suspension rules to section 987 gains and losses associated with historic assets only.

C. <u>For purposes of determining recognized section 987 gains and losses under Prop. Reg. §§ 1.987-5(c) and (d), include a carve-out / exemption from the recharacterization rules described in Treas. Reg. § 1.987-2(c)(2) for certain recurring interbranch and intercompany funding transactions undertaken by regulated global financial institutions. We would recommend leveraging the funding rule described in Treas. Reg. § 1.385-3(b)(3)(vii)(A) and the regulated financial company exception described in Treas. Reg. § 1.385-3(g)(3)(iv).</u>

In the ordinary course of their business, foreign branches of U.S. banks enter into a large number of interbranch and intercompany funding transactions. Such interbranch items are subject to various regulatory requirements relating to liquidity and similar considerations. As a result, financial institutions have a myriad of recurring transfers of funds taking place e.g., overnight placements, in a given year, both between foreign branches and their owners and among foreign branches. Such transfers can amount to thousands of transfers on different days during the year.

Banks typically hedge the "net equity" as measured in functional currencies of their branches different than the bank branch owner. An interbranch lending/borrowing will not change the foreign currency "net equity" of a branch and therefore does not change the currency exposure being hedged. It should not be considered a remittance or contribution because it is not a permanent transfer of funds. See example below.

Pursuant to Treas. Reg. § 1.987-2(c)(2) (and both Treas. Reg. § § 1.987-5(d) and (e) and 1.987-4(d)(2)-(5) which are dependent upon it) certain otherwise disregarded transactions between a section 987 foreign branch and its owner (or another eligible foreign branch of the owner) are recharacterized as a transfer and deemed remittance to its owner by a paying section 987 foreign branch or as a transfer and deemed contribution by the owner to a receiving section 987 foreign branch. Pursuant to Prop. Reg. § 1.987-5, a taxpayer would generally recognize section 987 gains and losses upon remittances from a section 987 foreign branch. Treas. Reg. § § 1.987-5(d) and (e) aggregates all disregarded contributions and remittances made during the year.

[15] To name a couple of examples: (i) In the subpart F context, if the aggregate of foreign base company income and insurance income of a CFC is less than the lesser of 5% of gross income of $1 million, no part of the income is treated as subpart F income (see 954(b)(3)(A)) and (ii), A taxpayer can treat original issue discount ("OID") as zero if the total OID on a debt instrument is less than one-fourth of 1% (0.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity (see Publication 1212).

Treating recurring regulated intercompany funding transactions as "transfers" of assets or liabilities can lead to significant distortions simply based on whether a foreign branch is a net lender or borrower with its owner or another foreign branch. If a foreign branch is a consistent net lender or net borrower, they will, respectively, be viewed as having perpetual deemed remittances and deemed contributions when there is no actual change to economic equity on the branch balance sheet. Thus, the treatment will not be aligned with hedging activities whereby traders are hedging the economic equity of the branches. Such hedging takes into account interbranch loans and borrowings as loans and borrowings and so the exposure hedged is not affected by them.

Further, characterizing a bank branch's interbranch loans as remittances and borrowings as contributions ignores the fact that such "contributions" and "remittances" are associated with an obligation by a regulated branch or its owner to repay them in the future. They are not permanent transfers of funds. Note also that generally, for other federal income tax purposes outside of section 987, a contribution or distribution to or from a branch or other disregarded entity and its owner would itself be disregarded. Thus, since for section 987 purposes the transfer of the currency itself is being regarded, the obligation of a regulated branch to repay or be repaid with respect to those transfers should also be regarded for section 987 purposes.

Based on the 2023 proposed regulations, as currently written, the above interbranch transactions would impact both unrecognized section 987 gains and losses pursuant to Prop. Reg. § 1.987-4 as well as the amount of recognized section 987 gains and losses pursuant to Prop. Reg. § 1.987-5, as a result of remittances and contributions.

Nonetheless, SIFMA is specifically focused on a carve-out for purposes of Prop. Reg. § 1.987-5 for purposes of distinguishing the types of interbranch transactions (described above) from real economic remittances and contributions. This issue can be illustrated in the example below:

<u>Example – Interbranch Loan</u>

<u>Facts</u>: Branch 1 and Branch 2 are branches of Branch Owner. Branch Owner's functional currency is USD. Branch 1's functional currency is Currency A. Branch 2's functional currency is Currency B. Branch 1 has 100A of assets and has 10 B of matching assets and liabilities which do not require hedging. Branch 2 has 100 B of assets. Branch 2 lends 10 B to Branch 1.

<u>Expected impact on Treas. Reg. § 1.987-5:</u>

Branch 2 will be viewed as remitting 10 B to Branch Owner although there has been no actual or economic remittance. The "remittance" is not permanent and is expected to be repaid as reflected on its books and records. As there has been no change in its "equity", i.e., its currency exposure, there will be no change in the exposure being hedged (Branch 2 equity is still 100 B and will be hedged).

Branch 1 will be viewed as receiving a contribution of 10 B from Branch owner although there has been no actual or economic contribution. The "contribution" is not permanent and is expected to be repaid as reflected on its books and records. As there has been no change in its "equity" i.e., currency exposure, there will be no change in the exposure being hedged (Branch 1 equity is still 100 A and will be hedged).

On a consolidated basis at the level of the Branch owner, 100 B of currency exposure remains to be hedged and 100 A of currency exposure to be hedged.

SIFMA Recommendation:

- It is SIFMA's recommendation that Treasury leverage the related-party debt-equity regulations under section 385; both the short-term funding rule arrangement exception described in Treas. Reg. § 1.385-3(b)(3)(vii)(A) and the regulated financial company exception described in Treas. Reg. § 1.385-3(g)(3)(iv). As the funding rule was in large part aimed at related party lending that funded "distributions," this seems potentially analogous to the relationship between interbranch loans and remittances.

- Proposed exclusions from Prop. Reg. § 1.987-2(c)(2) for purposes of determining remittances / contributions under Prop. Reg. § 1.987-5 should include the following:

    - All interbranch and inter branch/branch owner debt involving regulated financial companies and members of a regulated financial group; and

    - All other entities interbranch and interbranch/owner debt if it meets the qualified short-term funding exception described in Treas. Reg. § 1.385-3(b)(3)(vii)(A).[16]

D. *Clarify that applying the "earnings only" method or "earnings and capital" method, with modifications to make such methods administrable, is "any other reasonable" manner of applying such methods and would therefore qualify as an eligible pretransition method under Prop. Reg. § 1.987-10.*

As mentioned above, the overwhelming majority of global financial institutions have been applying the 1991 proposed regulations given the ratio of marked vs historic assets on the balance sheet.[17]

Prop. Reg. § 1.987-10 requires a taxpayer to assess whether it has applied an eligible pre-transition method under section 987 for its section 987 QBUs for purposes of computing its pre-transition section 987 gain or loss. An eligible pretransition method means any reasonable method of applying section 987 that a taxpayer applied consistently to each tax year preceding the transition date. For these purposes, a reasonable method includes (i) the "earnings and capital" method described in the 1991 proposed regulations and (ii) any method producing the same total amount of income as the "earnings and capital" method (over the life of the owner of the foreign branch). Notably, an earnings-only method that does not meet this standard will still qualify as an eligible pretransition method if (i) the method was first applied by the owner on a return filed before November 9, 2023 and (ii) the method was applied consistently to all section 987 foreign branches of the owner and (iii) the owner otherwise reasonably applied section 987**.**

Financial institutions have developed a range of methodologies (i.e., pursuant to the 1991 proposed regulations) since the enactment of the statute, in an effort to comply in good faith with the statutory text. Generally speaking, for purposes of tracking the pools of unrecognized section 987 gains and losses, financial institutions have maintained equity and basis pools for section 987 QBUs based on taxable income and actual contributions and remittances. E&P and taxable income of the foreign branches are generally tracked and accumulated by using the average rate for each year which has resulted in a blended average rate in the "earnings pool." Financial institutions generally have recognized section 987 gains and losses upon actual net remittances. The section 987 gain or loss is determined largely based on the difference between the spot rate and the average rate in the "earnings pool."

For reasons of administrability (as well as for the reasons noted above) some taxpayers may have deviated slightly or have made some modifications to the guidelines set forth in the regulations. For example, some institutions have not historically treated the large volumes of placements and deposits made by a section 987 foreign branch with its owner as remittances when determining whether section 987 gains or losses should be recognized.

[16] Note that the 270-day exception described in Treas. Reg. § 1.385-3(b)(3)(vii)(A) does not translate perfectly to the financial services industry which is why we are suggesting the modifications described above.

[17] As a result, very few financial institutions apply the FEEP methodology set forth in the 2016 proposed and final regulations.

SIFMA would therefore like to confirm that the applicable “earnings only” method, with *reasonable* deviations, would be considered applied “in a reasonable matter”[18] in order to avoid an unnecessary administrative and compliance burden for a taxpayer who made a best effort to apply the proposed regulations over the lifespan of its foreign branches.

SIFMA Recommendation:

- Clarify that applying the “earnings only” method or “earnings and capital” method, with modifications to make such methods administrable is “any other reasonable” manner of applying such methods and would therefore qualify as an eligible pretransition method under Prop. Reg. § 1.987-10.

- For example, clarify that an eligible pretransition method would include application of the 1991 proposed regulations, even if a taxpayer’s methodology included certain deviations, such as not treating interbranch placements, or loans as remittances (and therefore did not recognize section 987 gains and losses in connection with interbranch lending activities).

IV. Conclusion

SIFMA appreciates the opportunity to provide comments to the IRS and Treasury on these proposed Section 987 regulations, and we look forward to working with the government to finalize these regulations in a manner that is most relevant and accommodating to the business models, day-to-day operations and regulation of global banks, broker dealers and asset managers. Please contact PJ Austin (pjaustin@sifma.org) if you have any questions regarding this submission.

Respectfully submitted,

P.J. Austin

Vice President, Tax
SIFMA

Cc:

Scott Levine, Acting Deputy Assistant Secretary (International Tax Affairs), US Department of the Treasury

Lindsay Kitzinger, International Tax Counsel, US Department of the Treasury

Erika Nijenhuis, Senior Counsel, US Department of the Treasury

Paul Crispino, Attorney, International, US Department of the Treasury

Daniel McCall, Deputy Associate Chief Counsel (Technical), Office of the Associate Chief Counsel (International), Internal Revenue Service

Azeka Abramoff, Special Counsel, Office of Associate Chief Counsel (International)

[18] If a taxpayer is not on an eligible pretransition method then such taxpayer will be required to compute its pretransition section 987 gain and loss utilizing the FEEP methodology described in the 2023 proposed regulations, subject to certain modifications, by applying such methodology to all section 987 foreign branches from inception of such QBUs up until the transition date.

Peter Merkel, Branch Chief, Branch 5, Office of the Associate Chief Counsel (International), Internal Revenue Service

Raphael J. Cohen, Attorney Advisor, Branch 5, Office of the Associate Chief Counsel (International), Internal Revenue Service