SPECIAL REPORTS

Aggregate or Entity Theory of Partnerships for Currency?

by John D. Bates

John D. Bates is an associate at Ivins, Phillips & Barker in Washington.

The author thanks Robert Stack for his comments and insights on this report. Any views expressed are solely those of the author and not necessarily those of Ivins, Phillips & Barker. Any errors are the author's alone.

Outside subchapter K of the U.S. Internal Revenue Code, which provides the framework for the taxation of partners and partnerships, partnerships lead a schizophrenic existence, flickering in and out of being depending on where and under what circumstances one looks.[1] For some purposes, an aggregate or conduit theory applies, under which a partnership is treated as the collective identity of its partners, so that the partners are attributed activities, assets or liabilities, or other tax attributes of the partnership, or the treatment of partnership items is determined by reference to the attributes of the partners. For others, an entity theory applies, so that the partnership is respected as a body separate and distinct from its partners.

In many areas of cross-border tax law, the fundamental issue whether or for what purposes an aggregate or entity approach applies is settled, at least for the time being. Not so for subpart J of the code — sections 985 to 989, which, along with a smattering of other provisions, govern currency tax issues. Although final regulations have for more than two decades applied an entity approach for some currency purposes, the treatment of partnerships for other currency purposes has remained uncertain. In 2006 Treasury and the IRS issued proposed regulations that if finalized would adopt an aggregate approach under sections 987 and 988, the primary operative currency provisions.[2] Finalizing these regulations is among the projects included in the Treasury 2010-2011 priority guidance plan, and the treatment of partnerships is one of the thornier issues that should be addressed.

Although the technical aspects of applying an aggregate approach to partnerships for currency purposes and the administrative difficulties it would raise have rightfully received attention, the first question that must be answered is whether an aggregate or entity approach makes for better policy.[3] This article explores which approach is optimal from a policy perspective, balancing the foundational principles of two seemingly disjointed tax regimes: subchapter K's partnership tax rules and subpart J's currency rules. It argues for an entity approach under section 988 and, provided that

---

[1] *See generally* Youngwood and Weiss, ''Partners and Partnerships — Aggregate vs. Entity Outside of Subchapter K,'' 48 *Tax Law.* 39 (1994-1995); McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners* (4th ed., 2007), at para. 1.02; Willis and Postlewaite, *Partnership Taxation* (6th ed., 1997), at para. 1.04.

The term ''partnership'' as used in this article denotes a business entity classified as a partnership for U.S. federal income tax purposes, regardless of whether the entity or arrangement is a partnership for local law purposes.

[2] *Fed. Reg.* Vol. 71, No. 173, p. 52,876 (Sept. 7, 2006).

[3] Some commentators have argued in favor of an entity approach under section 987 for administrative, technical, and policy reasons. *See, e.g.*, ABA Section of Taxation, Comments on Proposed Regulations Under Section 987 (Feb. 24, 2010), at 18-23.

policymakers choose to adopt rules under section 987 similar to those set forth in the 2006 proposed regulations, under section 987 as well. Unlike areas of international tax law in which an aggregate approach is necessary to implement or safeguard the relevant policies, the currency rules primarily represent rules of measurement, computation, and characterization. An aggregate approach is unnecessary for these relatively prosaic functions and would be inconsistent with partnership tax principles favoring centralized measurement of income or loss at the partnership level and characterization of partnership tax items, including assets and liabilities, by taking into account only partnership (and not partner) attributes or activities. These generally applicable partnership tax principles appear to outweigh the rationale for adopting an aggregate approach described in the preamble to the 2006 proposed regulations.

Section I of this article sets the stage, outlining the basic currency rules involved. Section II makes the case that the statutory language, policies behind the currency and partnership tax rules, and administrative considerations, when considered in the aggregate, support an entity approach under section 988. Section III describes the functions served by section 987 and argues that as under section 988, the policies behind section 987 and partnership tax principles support an entity approach. Although section 987 has a dual nature, both of its functions are better carried out at the partnership level. Section IV, then, discusses issues for further consideration that an entity approach would raise.

I. Structure of the Currency Rules

To better understand the currency policies implicated, it is helpful to survey the operation of, and functions served by, sections 985 to 989. The primary subjects under the currency rules are taxpayers and qualified business units (section 989 QBUs). A taxpayer is ''any person subject to any internal revenue tax,''[4] and a section 989 QBU is ''any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.''[5] Although partnerships are not subject to U.S. federal income tax,[6] they are subject to other internal revenue taxes, such as federal employment taxes, and therefore qualify as taxpayers.[7] Existing regulations define section 989 QBUs as including partnerships (along with corporations, trusts, and estates, but not individuals),[8] as well as some activities conducted by individuals and entities (such as activities of partnerships) that rise to the level of a trade or business.[9] Thus, a partnership is a section 989 QBU, and the activities of the partnership can qualify as section 989 QBUs separate from the partnership.

Sections 985 through 989 include substantive, administrative, and definitional rules:

- Section 985 and the regulations thereunder govern a taxpayer's or section 989 QBU's functional currency and prescribe collateral consequences for a change in functional currency.[10] It also requires a taxpayer or section 989 QBU to make all tax determinations in its functional currency.[11] Any currency other than the taxpayer's or section 989 QBU's functional currency is referred to as nonfunctional currency.[12]

- Section 986 provides rules for denominating specified tax items (foreign taxes and earnings and profits of a corporation) in either functional or nonfunctional currency and for translating items denominated in nonfunctional currency into functional currency. It also requires income or loss to

[4]Section 7701(a)(14).

[5]Section 989(a).

[6]Section 701(a); reg. section 1.701-1.

[7]*See United States v. Galletti*, 541 U.S. 114 (2004); McKee, Nelson, and Whitmire, *supra* note 1, at para. 9.01[10]; Willis and Postlewaite, *supra* note 1, at para. 9.04[1].

[8]Reg. section 1.989(a)-1(b)(2)(i).

[9]Reg. section 1.989(a)-1(b)(2)(ii). A trade or business for these purposes generally is ''a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212.'' Reg. section 1.989(a)-1(c). Activities constituting a trade or business ordinarily must include ''every operation which forms part of, or a step in, a process by which an enterprise may earn income or profit, including the collection of income and the payment of expenses.'' *Id*. A vertical, functional, or geographic division of the same trade or business is itself a trade or business if it is capable of producing income independently. *Id*.

[10]Generally, a taxpayer's or section 989 QBU's functional currency is the U.S. dollar. Section 985(b)(1)(A); reg. section 1.985-1(b). The functional currency of a section 989 QBU, including a partnership or activities of a partnership, can be other than the U.S. dollar, however, if a significant part of the section 989 QBU's activities are conducted using another currency and the section 989 QBU maintains its books and records in such other currency. Section 985(b)(1)(B); reg. section 1.985-1(c). The section 989 QBU must use the U.S. dollar as its functional currency: if its operations are conducted primarily in U.S. dollars (section 985(b)(2); reg. section 1.985-1(b)(1)(ii)); if its principal place of business is located in the United States, so that its residence for purposes of section 988(a)(3)(B) is in the United States (reg. section 1.985-1(b)(1)(iii)); if the section 989 QBU's books and records are maintained using a currency of an economic environment in which the section 989 QBU does not conduct a significant part of its activities (reg. section 1.985-1(b)(1)(iv)); if the section 989 QBU's activities generate income or loss that is effectively connected with a U.S. trade or business (reg. section 1.985-1(b)(1)(v)); or, generally, if the section 989 QBU's functional currency otherwise would be a hyperinflationary currency (reg. section 1.985-1(b)(2)(ii)).

[11]Section 985(a); reg. section 1.985-1(a).

[12]Reg. section 1.988-1(c).

be recognized on some distribution of previously taxed earnings and profits (PTI), as discussed in Section III.

- Section 987 provides rules for translating foreign branch (a section 987 QBU) results into a taxpayer's functional currency and for taking into account foreign exchange gain or loss on the section 987 QBU's operations (section 987 gain or loss). Section 987 QBUs are a subset of section 989 QBUs, so that a section 987 QBU is also a section 989 QBU, but the converse is not necessarily true. The state of the law under section 987 has been uncertain since the provision was introduced in 1986, as final regulations have yet to be issued, and the two sets of proposed regulations that have been issued differ in important respects.
- Section 988 governs the tax consequences of specified financial transactions denominated in, or determined by reference to, nonfunctional currency (section 988 transactions). Section 988 transactions include, subject to exceptions, transactions involving nonfunctional currency itself and nonfunctional currency-denominated debt instruments, receivables and payables, and derivatives.[13] A taxpayer or section 989 QBU recognizes foreign exchange gain or loss on section 988 transactions.[14]
- Section 989 defines some of the terms of art used in subchapter J, including ''section 989 QBU''; sets forth rates for translating specified tax items from nonfunctional currency to functional currency; and grants policymakers authority to issue regulations under the currency rules.

The qualification of partnerships as both taxpayers and section 989 QBUs under current law has several implications. A partnership has a functional currency and all its tax items must be determined in its functional currency unless otherwise specified; the partnership's functional currency can be other than the U.S. dollar if it keeps its books and records in another currency that is the currency of an economic environment in which the partnership conducts a significant part of its activities; and the partnership's trades or businesses can constitute section 989 QBUs separate from the partnership. The questions addressed herein are how sections 987 and 988 should apply to partnerships and partners.

II. Partnerships Under Section 988

Although section 987 precedes section 988, this article discusses the treatment of partnerships under section 988 first because it is conceptually more straightforward than section 987, and section 987 builds on the functions carried out by section 988. The fundamental question is whether exchange gain or loss on transactions entered into by a partnership should be measured and taken into account at the partnership level and then allocated to the partners in accordance with subchapter K or, alternatively, measured and taken into account directly by the partners. For purposes of simplicity, except as otherwise noted, any section 988 transactions discussed herein are assumed to be attributable to a partnership itself, not to a section 987 QBU composed of the partnership's activities, which is separate from the partnership and could be subject to section 987. The treatment of section 988 transactions attributable to section 987 QBUs composed of partnership activities is discussed in Section III.

A. Current Law

Under current law, because partnerships automatically qualify both as taxpayers and section 989 QBUs, they recognize exchange gain or loss under section 988 on financial transactions undertaken in nonfunctional currency, and the partners take into account their distributive shares of such exchange gain or loss but do not compute their own exchange gain or loss with respect to the partnership's transactions. This results in a straightforward entity approach under section 988.

For example, assume that a partnership, P, is organized under the laws of Country X and uses the *x* as its functional currency. P has two corporate partners, A and B, each of which uses the U.S. dollar as its functional currency. P acquires and holds 100 units of *x*. Because P's functional currency is the *x*, its acquisition of 100*x* does not constitute a section 988 transaction, and P does not recognize exchange gain or loss on the disposition of the units, and no exchange gain or loss flows through to A or B. If, alternatively, A and B acquired and later disposed of the units of *x* themselves, the acquisitions and dispositions would constitute section 988 transactions, and A and B would recognize exchange gain or loss.

Now assume that P acquired and later disposed of $100. P would recognize exchange gain or loss on the U.S. dollars because they would constitute nonfunctional currency (the exchange gain or loss would be measured in terms of *x*), and this exchange gain or loss would flow through to A and B (it would need to be translated into U.S. dollar terms, however). In contrast, if A and B acquired and later disposed of the $100

[13] Section 988(c)(1); reg. section 1.988-1(a)(1). Section 988 does not apply to nonfinancial property transactions, even if changes in the value of the property in terms of the taxpayer's functional currency correlate with currency fluctuations. For example, assume a taxpayer with the U.S. dollar as its functional currency purchases land in Country X, which uses the *x* as its currency. Even though changes in the value of the land in U.S. dollar terms might correlate at least in part with the value of the U.S. dollar relative to the *x* because the rents received from the property are denominated in *x*, no part of the taxpayer's gain or loss is treated as exchange gain or loss.

[14] Reg. section 1.988-2.

themselves, the transactions would not give rise to exchange gain or loss because A's and B's functional currencies are the U.S. dollar.

B. 2006 Proposed Regulations

The 2006 proposed regulations would modify the section 988 rules to apply an aggregate approach to partnerships. To implement this change, the 2006 proposed regulations would modify the definition of a section 989 QBU to exclude partnerships,[15] so that a partnership would be required to use the U.S. dollar as its functional currency, because only a taxpayer that also qualifies as a section 989 QBU can use a functional currency other than the U.S. dollar.[16] If an asset or liability held by a partnership were not attributable to activities of the partnership that qualify as a section 987 QBU of the partners, a concept discussed in Section III, the partners would be treated as owning their proportionate shares of the asset or liability.[17] For tiered partnerships, an aggregate approach would apply at each level, so that the individual or corporate partners at the top of the chain of partnerships would be treated as owning the assets or liabilities of the partnerships for currency purposes. Thus, whether a partnership's transactions constitute section 988 transactions and thereby generate exchange gain or loss would be determined by reference to the functional currencies of the partners, and exchange gain or loss would be measured and taken into account at the partner level. This means that a partnership transaction might constitute a section 988 transaction to some but not all the partners.

For example, assume that a partnership, P, uses the U.S. dollar as its functional currency, and P has two corporate partners, A and B. A uses the U.S. dollar as its functional currency, and B, a Country X controlled foreign corporation, uses the *x*. P issues a debt instrument denominated in *x* that is not attributable to a section 987 QBU. Whether the transaction constitutes a section 988 transaction is determined by reference to A's and B's functional currencies. The debt issuance would not constitute a section 988 transaction to B because B's functional currency is the *x*. A, however, would recognize exchange gain or loss on its share of the debt obligation.

C. Entity Approach — Section 988

This proposed aggregate approach would represent a novel and, this article argues, unwarranted change. Section 988's statutory language and legislative history indicate that Congress did not contemplate that an aggregate approach would apply, and more important, currency and partnership tax policies on balance support an entity approach.

Regarding the statutory language, a section 988 transaction includes specified financial transactions:

> if the amount which the *taxpayer* is entitled to receive (or is required to pay) by reason of such transaction —
>
> > (i) is denominated in terms of a nonfunctional currency, or
> >
> > (ii) is determined by reference to the value of 1 or more nonfunctional currencies.[18] [Emphasis added.]

A partnership, as a taxpayer, has a functional currency, and therefore the plain language of the statute suggests that Congress anticipated that the determination whether a partnership transaction constitutes a section 988 transaction would be made at the partnership level, not the partner level.

The plain reading is supported by the remainder of the statute as well. Congress specially granted authority for aggregate treatment to apply for limited purposes in section 988, indicating that if Congress had contemplated that an aggregate approach would apply generally under the statute, it would have made that intention clear. Exchange gain or loss reflected on a partnership's books and records generally is sourced by reference to the residence of the partnership: the United States if the partnership is a U.S. person and a foreign country if the partnership is a foreign person.[19] Congress, however, contemplated that regulations could adopt an aggregate approach for sourcing purposes. Section 988(a)(3)(B)(iii) states:

> Special rule for partnerships. To the extent provided in regulations, in the case of a partnership, the determination of residence shall be made at the partner level.[20]

That Congress deemed it necessary to provide explicit authority for regulations to apply an aggregate approach for purposes of sourcing exchange gain or loss supports the conclusion that it did not expect that an aggregate approach would apply generally.[21]

The purpose of discussing section 988's statutory language is not to argue that an aggregate approach would be invalid. Congress granted to policymakers

[15]Prop. reg. section 1.989(a)-1(b)(2)(i).

[16]Reg. section 1.985-1(b)(1)(i).

[17]Prop. reg. section 1.988-1(a)(4).

[18]Section 988(c)(1)(A).

[19]Section 988(a)(3)(A) and (B).

[20]The regulations follow this statutory cue. *See* reg. section 1.988-4(d)(3). Section 988 singles out partnerships for special treatment for other limited purposes, as well. *See* section 988(c)(1)(D) and (E). This suggests that except in these circumstances, Congress expected that partnerships would be subject to the same rules as other taxpayers.

[21]There is no suggestion in the legislative history that an aggregate approach would apply. *See generally* H.R. Rep. No. 99-841 (Conference Committee Report), at II-662-64 (1986); Staff of the Joint Committee on Taxation, ''General Explanation of the Tax Reform Act of 1986'' (JCT General Explanation), at 1,096-1,108 (1987).

latitude to apply whichever of an aggregate or entity approach is more appropriate for areas outside subchapter K,[22] and also to prescribe regulations to promote the policies of subpart J.[23] Rather, the statutory language and legislative history frame the inquiry. Unless policy considerations strongly support an aggregate approach, the statutory language and Congress's expectation that an entity approach would apply should be given effect.

It happens that in this case the relevant currency and partnership tax principles also support an entity approach. Partnership tax law evinces a strong preference for centralized measurement and computation of income or loss on transactions undertaken by a partnership and for characterization of assets or liabilities of a partnership at the partnership level, rather than at the partner level.[24] Regarding measurement and computation, a partnership's taxable income or loss is computed as it would be for an individual, subject to specified modifications.[25] Although some partnership items that can affect the respective tax liabilities of the partners differently must be separately stated by a partnership and separately transmitted to the partners,[26] these items nonetheless are measured in the first instance at the partnership level and allocated to the partners according to the rules of section 704(b).

[22]*See* H. Conf. Rept. 2543, 83d Cong. 2d Sess. (1954).

[23]Section 989(c).

[24]*See, e.g.*, McKee, Nelson, and Whitmire, *supra* note 1, at para. 9.01[2]. For example, the Supreme Court in *United States v. Basye*, 410 U.S. 441 (1973), explained:

> Section 703 of the Internal Revenue Code of 1954, insofar as pertinent here, prescribes that ''[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual,'' 26 U.S.C. [section] 703(a). Thus, while the partnership itself pays no taxes, 26 U.S.C. [section] 701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.

Basye, 410 U.S. at 448.

[25]Section 703(a). Further, a partnership has its own tax year (section 706(a)), all but a few enumerated tax elections are made at the partnership level (section 703(a) and (b); reg. section 1.703-1(b)(1)), and case law provides that the clear reflection of income tax accounting standard of section 446(b) is applied at the partnership level. *See Resnik v. Commissioner*, 66 T.C. 74 (1976), *aff'd per curiam*, 555 F.2d 634 (7th Cir. 1977).

[26]Section 702(a); reg. section 1.702-1(a)(8)(i); section 703(a)(1). For a discussion of the partnership items that must be separately stated, see, for example, McKee, Nelson, and Whitmire, *supra* note 1, at para. 9.01[3].

The characterization of tax items also typically takes place at the partnership level, so that the character of the items remains the same when they are transmitted to the partners. Section 702(b) provides:

> The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under [section 702(a)(1) through (7), which requires partners to take into account their distributive shares of specified partnership items separately] shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.[27]

Courts consistently have interpreted section 702(b) to require partnership-level characterization of tax items earned or incurred by the partnership.[28] Such partnership-level determinations include: whether a partner's distributive share of gain or loss recognized by a partnership on the sale or exchange of an asset is capital or ordinary[29]; whether partnership expenditures are deductible or must be capitalized[30]; and whether losses recognized on loans held by the partnership may be deducted as bad debt.[31]

A common theme in these cases is that if the characterization of a tax item or asset or liability depends on its relationship to business activities or intent, only the partnership's and not the partners' business activities or intent are taken into account. A leading treatise on the taxation of partnerships explains in this regard:

> Those cases that have directly considered whether partnership items should be characterized at the partner or partnership level have generally concluded that the characterization question should

[27]Reg. section 1.702-1(b) restates this characterization rule and adds illustrations:

> For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership ''hobby losses'' (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

[28]*See Davis v. Commissioner*, 74 T.C. 881, 905-906 (1980), *aff'd*, 746 F.2d 357 (6th Cir. 1984) (stating that section 702(b) ''has been consistently interpreted to mean that the character of partnership income is determined at the partnership level'').

[29]*See, e.g.*, *Podell v. Commissioner*, 55 T.C. 429 (1970). Further, whether a partner's distributive share of capital gain recognized by a partnership is long term or short term is determined based on the partnership's holding period regarding the asset, not the partner's holding period regarding its partnership interest. *See* Rev. Rul. 68-79, 1968-1 C.B. 310.

[30]*See, e.g.*, *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

[31]*John D. Cole*, T.C. Memo. 1962-287.

> be resolved at the partnership level, and the Service clearly shares this view. . . .
>
> Under the statute, the taxation of partnership activities to its partners is accomplished in three sequential steps, as follows:
>
> 1. Segregated items of partnership income or expense and bottom-line partnership taxable income are computed under [section] 702(a);
>
> 2. Each partner's distributive share of each segregated item and share of bottom-line partnership taxable income are determined under [section] 704; and
>
> 3. Under [section] 702(a), each partner takes into account his distributive share of each segregated item and share of bottom-line partnership taxable income in determining his income tax.
>
> This sequence of events assumes that the character of partnership income and expense items should be determined in connection with the first step, that is, the calculation of bottom-line partnership taxable income and segregated items at the partnership level pursuant to [section] 702. Thus, it is not until the second step, namely, the application of [section] 704, that the partners' distributive shares are determined. Conversely, if character were required to be determined at the partner level, the second step would have to be accomplished before the first. This reversal would be difficult or impossible to accomplish in application, and does not seem to have been contemplated by the drafters of these provisions.[32]

Although exceptions to this general principle can arise when necessary to uphold particular policies,[33] section 988 reflects straightforward rules of measurement, computation, and asset and liability characterization, underscoring that despite falling within the 900s of the code, the currency rules are fundamentally unlike other areas of international tax where an aggregate approach to partnerships has been needed to prevent abuse.[34] In this case, the partnership tax principles of centralized measurement and computation of tax items resulting from a partnership's operations and characterization of assets and liabilities held by the partnership at the partnership level should control the discussion.

A taxpayer has a single functional currency so that its tax results can be calculated and reported using a uniform standard of value or unit of account. The functional currency concept was borrowed from Financial Accounting Standards No. 52, ''Foreign Currency Translation,''[35] which states:

> Because it is not possible to combine, add, or subtract measurements expressed in different currencies, it is necessary to translate into a single reporting currency those assets, liabilities, revenues, expenses, gains, and losses that are measured or denominated in a foreign currency.[36]

Although FAS 52 was discussing the rationale behind adopting the functional currency concept in the financial accounting context, the same considerations are relevant in the tax context as well. Consistent with viewing functional currency as a concept of measurement and computation, a taxpayer's or section 989 QBU's functional currency is treated as a method of accounting,[37] and adjustments are required if a taxpayer or section 989 QBU changes its functional currency to avoid leakage of built-in but yet unrecognized exchange gain or loss in the transition.[38]

Section 988's requirement that taxpayers recognize exchange gain or loss on nonfunctional currency financial transaction grew out of case law and administrative rulings treating foreign currency as personal property, not money. The Joint Committee on Taxation described the state of the law at the time section 988 was enacted as follows:

> When a U.S. taxpayer uses foreign currency, gain or loss (referred to as ''exchange gain or loss'') may arise from fluctuations in the value of the foreign currency relative to the U.S. dollar. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.[39]

For example, in *Wheatley v. Commissioner*, 8 B.T.A. 1246 (1927), the U.S. Tax Court considered the treatment of a U.S. citizen who resided in Argentina during the year and earned Mexican pesos. Concluding that the taxpayer recognized a loss on the depreciation of the peso against the U.S. dollar between when he acquired the pesos and when he used the pesos to purchase a note denominated in U.S. dollars, the court explained:

---

[32]McKee, Nelson, and Whitmire, *supra* note 1, at para. 9.01[4][a] (footnotes from quoted text omitted).

[33]For a discussion of these exceptions, see *id.* at para. 9.01[4][b].

[34]Aside from providing special sourcing rules for exchange gain or loss, the currency rules do not have any direct relevance to international policies such as allocating taxing jurisdiction between countries or preventing double taxation and double nontaxation.

[35]JCT General Explanation, *supra* note 21, at 1,086, footnote 36.

[36]FAS 52 (Dec. 1981), at para. 4.

[37]Reg. section 1.985-4(a).

[38]Reg. section 1.985-5.

[39]JCT General Explanation, *supra* note 21, at 1068. *Cf.* FAS 52 (Dec. 1981), at para. 15 (providing for foreign translation gain or loss to be taken into account in determining net income for financial accounting purposes).

> Petitioner is an American citizen and as such must pay an income tax on his earnings, regardless of the place of his residence or the fact that his entire income was earned in Buenos Aires. His standard for measuring the amount of his annual income was the American dollar. Paper pesos were nothing more than a commodity, which, for tax purposes, must be translated into American dollars. During his stay in Buenos Aires, he had accumulated 500,000 paper pesos which when earned bore the normal rate of exchange. It was in effect the same as if he had lived in Cincinnati during the entire time of his residence in Buenos Aires, and had purchased, with his capital, paper pesos at the normal rate of exchange, and in the year 1921, he sold the paper pesos, converting the same into his standard, i.e., American dollars. Petitioner, in effect, did this when he converted sufficient paper pesos to buy a draft for $5,000 and the difference between the rate at which he secured the paper pesos and the rate at which he disposed of the paper pesos constitutes a deductible loss sustained in the year 1921.[40]

Section 988's primary purpose, thus, is straightforward. The functional currency concept permits uniform measurement of tax results using a single unit of account. As with property transactions generally, if the value of a nonfunctional currency-denominated financial asset or liability increases or decreases in functional currency terms as a result of fluctuations in exchange rates, the taxpayer's economic position in terms of its functional currency is correspondingly improved or worsened. Upon the occurrence of a recognition event or other appropriate event, then, the taxpayer takes into account such economic gain or loss for tax purposes.[41]

Because section 988 transactions include only financial transactions denominated in nonfunctional currency, they derive their status as section 988 transactions by reference to the factors governing the functional currency determination. Congress deemed it appropriate to determine the functional currency of a section 989 QBU with a non-U.S. dollar functional currency by reference to the primary economic environment in which the QBU conducts business activities and the currency in which its books and records are maintained.[42] Factors relevant in determining whether a significant portion of such a section 989 QBU's activities are conducted in an economic environment include:

- the section 989 QBU's residence for currency purposes;
- the currencies of the section 989 QBU's cash flows;
- the currencies in which the section 989 QBU generates revenues and incurs expenses;
- the currencies in which the QBU borrows and lends;
- the currencies of the section 989 QBU's sales markets; and
- the currencies in which the section 989 QBU's pricing and other financial decisions are made.[43]

Thus, for section 989 QBUs that use a functional currency other than the U.S. dollar, section 988 transactions derive their status as such from the location and nature of the section 989 QBU's business activities.

---

[40]*Wheatley*, 8 B.T.A. at 1249. *See also Gillin v. U.S.*, 423 F.2d 309, 311 (Ct. Cl. 1970); *KVP Sutherland Paper Co. v. U.S.*, 344 F.2d 377 (Ct. Cl. 1965). Before the enactment of section 988, whether gain or loss on the disposition of foreign currency was capital or ordinary was determined under the generally applicable character rules. *See* Rev. Rul. 74-7, 1974-1 C.B. 198; Rev. Rul. 75-104, 1975-1 C.B. 18.

[41]Section 988 embodies aspects of the separate transaction doctrine, which was developed through case law and administrative guidance before the enactment of subpart J. *See generally* H.R. Rep. No. 99-426, at 449 (1985). Under the separate transaction doctrine, a taxpayer measured and recognized exchange gain or loss separately from other gain or loss on foreign-currency-denominated financial transactions. The JCT explained in this regard:

> New section 988 prescribes rules for the treatment of exchange gain or loss from transactions denominated in a currency other than a taxpayer's functional currency. For taxpayers using the U.S. dollar as a functional currency, the Act generally retains the prior law principles under which the disposition of foreign currency results in the recognition of gain or loss, and the Act partially retains prior law principles under which exchange gain or loss is separately accounted for (apart from any gain or loss attributable to the underlying transaction).

(Footnote continued in next column.)

JCT General Explanation, *supra* note 21, at 1,096.

Under section 988, exchange gain or loss on the transaction generally is not netted against the other gain or loss recognized on the transaction and is subject to special source and character rules. Typically, all the gains and losses on a disposition of nonfunctional currency or a transaction involving a nonfunctional currency forward, future, option, or notional principal contract will be attributable to fluctuations in the exchange rate and therefore constitute exchange gains or losses. Reg. section 1.988-2(d)(2)(i). In comparison, economic gains or losses on an account receivable or payable or under a debt instrument may also reflect non-currency gains or losses. For example, loss on the disposition of a debt instrument may represent a mix of loss due to exchange rate fluctuations and loss due to a decrease in the creditworthiness of the borrower or an increase in interest rates. In that situation, the currency loss is calculated based on the original value of the debt instrument, and the market loss equals the excess of the total loss recognized upon disposition, less the exchange loss. *See, e.g.*, reg. section 1.988-2(b)(9), Example (5)(ii). Currency gain or loss recognized on a debt instrument is limited to the overall gain or loss recognized on the instrument. Reg. section 1.988-2(b)(8).

[42]Section 985(b)(1)(B).

[43]Reg. section 1.985-1(c)(2)(i).

Given that section 988 is needed to measure properly a taxpayer's economic income or loss in terms of functional currency — and given that for section 989 QBUs that use functional currencies other than the U.S. dollar, section 988 transactions derive their status as such from their relationship to the location and nature of business activities — the generally applicable partnership tax principles discussed herein strongly support partnership-level determinations. These partnership tax principles appear to outweigh the points raised in the preamble to the 2006 proposed regulations in support of an aggregate approach: that an aggregate approach preserves the correct amounts of foreign exchange gain or loss and measures such gain or loss by reference to the functional currencies of the persons who bear the economic risk of exposure to movements in exchange rates.

Although the preamble to the proposed regulations did not provide a substantive rationale for applying an aggregate approach under section 988 specifically, it did explain the rationale for adopting an aggregate approach under section 987, and because sections 988 and section 987 act as substitutes for purposes of measuring exchange gain or loss, as discussed in Section III of this article, it is reasonable to conclude that the rationale under section 988 was the same. The preamble stated, in relevant part:

> With respect to partnerships, the IRS and Treasury Department recognize that issues often arise as to whether the international tax provisions of the Code operate on an aggregate or an entity basis. . . .
>
> The IRS and the Treasury Department believe that, on balance, an aggregate approach is more appropriate for section 987 purposes. Applying the foreign exchange exposure pool method directly at the partner level will more appropriately preserve the correct amounts of exchange gain or loss. In addition, such approach will measure the foreign currency exposure by reference to the functional currencies of the persons who generally bear the economic risk from such exposure.[44]

The preamble noted, however, that the aggregate treatment of partnerships under section 988 was intended to have a limited effect because it would not apply to assets or liabilities attributable to a section 987 QBU composed of the partnership's activities, as discussed in Section III, and presumably most partnership assets and liabilities would be attributable to section 987 QBUs.[45]

The discussion in the preamble appears to conflate tax risk with economic risk. Individual and corporate partners in a partnership, and not the partnership itself, bear the risk of increased or decreased tax liability from gain or loss on partnership currency transactions recognized as a result of movements in exchange rates. This, however, merely reflects the fact that partnerships are passthrough entities that are not themselves subject to tax, and does not mean that partnerships fail to bear economic risk on their transactions.

The opposite is true. Taxable income or loss is generally measured at the partnership level based on the partnership's actual transactions because a partnership *is* exposed to economic risk of gain or loss on such transactions. The partners indirectly also bear risk of economic gain or loss on partnership transactions as a result of owning interests in the partnership. Thus, both the partnership and the partners are exposed to economic risk on currency movements, and whether it is appropriate to measure the tax consequences of such economic results at the partner or partnership level should be determined within the same rubric that applies in evaluating whether other tax determinations are made at the partnership or partner level. Simply put, there does not appear to be a compelling reason why the entity approach that has been judged generally appropriate for other partnership computation and characterization determinations is not equally appropriate under section 988. As discussed in Section III, if policymakers are concerned that an aggregate approach could lead to abuses, more targeted solutions would be preferable.

---

[44] *Fed. Reg.*, Vol. 71, No. 173, at 52,881.

[45] The preamble stated:

(Footnote continued in next column.)

> As discussed above, the IRS and the Treasury Department will generally apply either an entity or an aggregate approach with respect to partnerships depending on which approach more appropriately carries out the purpose of the particular Code section under consideration. Following the amendments made by the proposed regulations, and because only certain activities of a partnership (and not the partnership itself) can qualify as a [section 987], the IRS and the Treasury Department believe that it is appropriate, in cases where an asset or liability of a partnership is not reflected on the books and records of an eligible QBU of the partnership, to determine whether section 988 applies by reference to the functional currencies of the partners. The IRS and the Treasury Department believe that this rule will have limited application and will apply, for example, where the only activity of a partnership is the incurrence of a liability used to acquire stock that is held by the partnership.

Fed. Reg., Vol. 71, No. 173, at 52,884. As discussed in Section III, with respect to the owner of a section 987 QBU, the section 987 regime in effect supplants section 988 for transactions undertaken by the section 987 QBU in the QBU's functional currency, and section 988 applies at the level of the section 987 QBU for transactions undertaken by the QBU in a currency other than either its own or the owner's functional currency.

Considerations of administrability lend further support to an entity approach, because it is not clear that an aggregate approach could prove workable even if it were necessary. Section 988 is computationally intensive,[46] and applying it at the partner level would require that partners have timely access to information regarding transactions undertaken by the partnership. It seems unrealistic to expect that partners, particularly minority partners, would have access to the needed information. Another practical problem is that there is no uniform formula that could be used to identify a partner's share of a particular asset or liability held by a partnership with reasonable certainty. Under the 2006 proposed regulations, a partner's share of an asset or liability for purposes of section 988 would be determined ''in a manner that is consistent with the manner in which the partners have agreed to share the benefits and burdens (if any) corresponding to the [asset or liability], taking into account the rules and principles of [subchapter K] and regulations thereunder.''[47] The problem is that partnerships often represent complicated arrangements, with a partner's interest entitling it to a share of profits and distributions but not a particular interest in an asset or liability. Indeed, other tax provisions that require a partner to take into account its share of assets or liabilities held by the partnership often resort to amorphous multi-factor tests or simplifying conventions,[48] or alternatively require complicated and detailed rules.[49] A nebulous or multi-factored ownership test would not fit well with the computational precision required by section 988.

III. Partnerships Under Section 987

It is impractical for a taxpayer to determine the tax consequences of transactions in its functional currency and recognize exchange gain or loss transaction by transaction if the taxpayer conducts a high volume of financial transactions through a foreign branch using nonfunctional currency and reports its operations in such nonfunctional currency for financial accounting purposes. The taxpayer would need to translate the amounts it pays and receives in each of the numerous transactions it conducts using the nonfunctional currency, and would have to maintain separate books in its functional currency exclusively for U.S. federal income tax purposes. This is where section 987 comes in.

Section 987 raises fundamental questions regarding partnerships, and whether an aggregate or entity approach applies affects both whether the section 987 gain or loss is measured and taken into account at the partnership or partner level, as well as whether a section 987 QBU's earnings must be translated at the partnership or partner level. Under a pure entity approach, a partnership would be subject to section 987 regarding a section 989 QBU composed of activities conducted by the partnership through a branch that uses a different functional currency than the partnership itself. (The activities thus would qualify as a section 987 QBU of the partnership.) Section 987 gain or loss would be determined at the partnership level, measured regarding the activities of section 987 QBUs owned by the partnership by reference to the partnership's functional currency and, only after such section 987 gain or loss is measured at the partnership level, allocated to the partners. Further, the section 987 QBU's operating results would be translated into the partnership's functional currency. As discussed in Section IV, it also could be possible under an entity approach for the partnership itself to constitute a section 987 QBU of some of its partners if the partnership uses a different functional currency from those partners. If section 987 were applied a second time, section 987 gain or loss would be determined again, this time at the partner level. Regardless of whether section 987 were applied at the partner level, if the partnership had a different functional currency from its partners, the partnership's net income or loss would need to be translated into the partners' functional currencies for purposes of determining the partners' taxable income or loss.

In contrast, under a pure aggregate approach, one would look through the partnership entirely, so that the partnership's activities could constitute section 987 QBUs of the partners. Section 987 gain or loss would be measured on the partnership's activities by reference to the partners' respective functional currencies, and it would be taken into account only at the partner level. Also, the section 987 QBU's results would be translated directly into the functional currencies of the partners at the partner level, without first translating the results into the functional currency of the partnership.

As an example, assume that a partnership, P, uses the U.S. dollar as its functional currency. P has two corporate partners: A, a domestic corporation that uses the U.S. dollar as its functional currency; and B, a Country X CFC that uses the *x* as its functional currency. P conducts a business through a branch in Country X. If an entity approach applied, the branch could constitute a section 987 QBU with P as the owner. P would recognize section 987 gain or loss with respect to the section 987 QBU based on the movements in the exchange rate between the U.S. dollar and the *x*. Further, the section 987 QBU's operating results would need to be translated from *x* into U.S. dollars, the functional currency of P. A and B would take into account their respective shares of P's section 987 gain or loss and the income or loss of the section 987 QBU taken into account by P. At a minimum, translation

[46] *See, e.g.*, reg. section 1.988-2; reg. section 1.988-5.

[47] Prop. reg. section 1.988-1(a)(4)(ii); prop. reg. section 1.987-7(b).

[48] *See, e.g.*, reg. section 1.613A-3(e)(4); reg. section 1.861-9T(e).

[49] *See* reg. sections 1.752-1 through 1.752-7.

rules would be needed to convert B's share of P's items of income or loss from U.S. dollars into *x*.[50]

In contrast, if an aggregate approach applied, P's branch activities could constitute a section 987 QBU with respect to A (A's share of the branch's assets and liabilities would constitute the balance sheet of the section 987 QBU) but not with respect to B because the functional currency of both B and the branch would be the *x*. A would determine its section 987 gain or loss with respect to its share of the branch's assets and liabilities, and translation rules would be needed to translate its share of the branch's income or loss into U.S. dollars.

To make sense of how aggregate and entity approaches would lead to different results and to evaluate which approach is optimal, it is necessary first to understand the functions served by section 987.

A. Principles Behind Section 987

Identifying the functions served by section 987 is made more complicated by the vagueness of the statutory language, the ambiguity and arguable inconsistency in the legislative history, and the divergence of approaches taken by policymakers in two sets of proposed regulations. Under the 2006 proposed regulations, however, section 987 serves two clear functions: First, it provides for the translation of a section 987 QBU's results into the owner's functional currency, and second, it acts as a substitute for applying section 988 to the assets and liabilities indirectly held by the owner through the section 987 QBU. This section will argue that these two functions are better carried out for partnerships through an entity approach.

Before discussing partnerships, however, section 987 must be unpacked, and a helpful first step in understanding section 987's functions is to work through the statutory language. Section 987 states, in full:

> In the case of any taxpayer having 1 or more qualified business units with a functional currency other than the dollar, taxable income of such taxpayer shall be determined —
>
> (1) by computing the taxable income or loss separately for each such unit in its functional currency,
>
> (2) by translating the income or loss separately computed under paragraph (1) at the appropriate exchange rate, and
>
> (3) by making proper adjustments (as prescribed by the Secretary) for transfers of property between qualified business units of the taxpayer having different functional currencies, including —
>
> (A) treating post-1986 remittances from each such unit as made on a pro rata basis out of post-1986 accumulated earnings, and
>
> (B) treating gain or loss determined under this paragraph as ordinary income or loss, respectively, and sourcing such gain or loss by reference to the source of the income giving rise to post-1986 accumulated earnings.

Despite section 987's relative brevity, it embodies several layered concepts and leaves significant questions regarding how it should apply open to interpretation. Paragraph (1) requires a taxpayer (the owner) to determine the branch QBU's taxable income or loss using the branch QBU's functional currency; paragraph (2) requires the taxable income or loss calculated under paragraph (1) to be translated at an exchange rate specified in section 989, namely, the average exchange rate for the tax year; and paragraph (3) anticipates that the owner will recognize exchange gain or loss (section 987 gain or loss) on the branch QBU's operations. What is less clear from the statute is how an owner measures, and when it takes into account, such section 987 gain or loss.

1. Net Worth and Profit and Loss Methods

To fully understand the statutory language and the approach adopted in the 2006 proposed regulations, it is useful to delve into the historical treatment of foreign branches and the legislative history behind section 987. During the period leading up to Congress's enactment of section 987, accounting for foreign branch operations largely was governed by a pair of revenue rulings that set forth alternative methods: the net worth method and the profit and loss method.[51] A taxpayer was permitted to use either method so long as it maintained the branch's books and records in a foreign currency and the method clearly reflected the branch's income.[52]

Under the net worth method, the owner's annual income or loss from the foreign branch equaled (i) the increase or decrease in the net value of the branch in terms of U.S. dollars during the year, plus (ii) distributions by the branch, less (iii) contributions by the owner to the branch, with the distributions and contributions translated into U.S. dollars at the exchange rate

[50]As discussed in Section IV, it also is possible that P could be treated as a section 987 QBU of B, in which case section 987 would be applied at the partner level with respect to B's partnership interest in P.

[51]*See* Rev. Rul. 75-106, 1975 C.B. 31, *obsoleted by* Rev. Rul. 2003-99, 2003-34 IRB 388; Rev. Rul. 75-107, 1975-1 C.B. 32, *obsoleted by* Rev. Rul. 2003-99, 2003-34 IRB 388.

[52]Rev. Rul. 75-109, 1975-1 C.B. 69. A taxpayer could use any generally accepted method of accounting for foreign branches, so long as the taxpayer did so consistently. *See American Pad & Textile Co. v. Commissioner*, 16 T.C. 1304 (1951).

on the date of the distribution or contribution. Thus, the distributions and contributions effectively were backed out so the net change in the value of the branch resulting from current-year operations would be isolated, serving as proxy for the operating profit or loss.

In effect, the owner marked the branch's net current assets or liabilities to market at the end of each year, annually taking into account any gain or loss on such assets and liabilities attributable to movements in the exchange rates as branch income or loss.[53] Marking to market the branch's current assets and liabilities should be viewed as a substitute for requiring the owner to recognize exchange gain or loss on foreign currency and foreign currency-denominated receivables and payables, as was required under case law and administrative rulings at the time and as is now required under section 988.[54] In this same sense, foreign branch accounting under section 987 cannot be severed from the function of section 988, and to the extent they act as substitutes, the two provisions should be implemented in a consistent manner with respect to partnerships.

In comparison, under the profit and loss method, branch income or loss equaled the sum of (i) any current year profits of the branch remitted to the owner during the year, translated into U.S. dollars at the spot exchange rate on the date of the remittances, plus (ii) the unremitted net profit or loss of the branch, translated into U.S. dollars using the exchange rate on the last day of the year. The profit and loss method, unlike the net worth method, did not involve a substitute for recognizing exchange gain or loss on foreign currency-denominated financial transactions. It simply provided translation rules for taking into account current-year income or loss of the branch.[55]

Although the legislative history behind section 987 evinces that Congress generally preferred the profit and loss method over the net worth method, Congress did not adopt the profit and loss method wholesale, as it also required that an owner recognize exchange gain or loss on remittances (transfers of money or cash) from a branch QBU to its owner.[56] Under House and Senate bills drafted in the lead up to the Tax Reform Act of 1986, an owner of a section 987 QBU would have recognized exchange gain or loss similarly to how U.S. shareholders are required to take into account income or loss as a result of currency movements regarding PTI of CFCs under section 986(c). A foreign corporation's earnings and profits are determined in the foreign corporation's functional currency,[57] and a shareholder takes into account a dividend from the foreign corporation by translating the distributed E&P using the spot exchange rate on the date of the distribution.[58] Subpart F, an anti-deferral regime, accelerates taxation in the United States of certain mobile or passive E&P of CFCs by deeming the CFC to have distributed the E&P to its U.S. shareholders, even if the E&P are not actually distributed until a later year.[59] Generally, if E&P are deemed distributed under subpart F, such E&P constitute PTI, and the U.S. shareholder is not taxed for a second time upon the actual distribution of the PTI by the CFC.[60] The U.S. shareholder, however, recognizes income or loss based on the difference between the average exchange rate for the year in which the PTI was deemed distributed under subpart F and the exchange rate on the date it actually is distributed.[61] The rationale is that the shareholder recognizes more or less economic gain on the actual distribution than was taken into account for tax purposes at the time of the subpart F inclusion, as a result of exchange rate fluctuations between the time of the deemed distribution and the time of the actual distribution.

Under the House and Senate bills, section 987 would have required an owner to account for its foreign branch's operations annually using a profit or loss method, translating the branch's net income or loss into U.S. dollars at the average exchange rate for the year, and the owner would have recognized exchange gain or loss upon remittances of cash or property to

---

[53]The branch's net value at the beginning of the year equaled the sum of (i) the branch's current assets less its current liabilities, translated into U.S. dollars using the spot exchange rate on the first day of the tax year, plus (ii) the branch's basis in its noncurrent assets, translated into U.S. dollars using the exchange rate on the date the asset was acquired, less (iii) the branch's noncurrent liabilities, translated into U.S. dollars using the exchange rate on the date the liability was incurred. The branch's net value at the end of the year was calculated similarly, except the net current assets or liabilities were translated using the spot exchange rate on the last day of the year.

[54]*See, e.g.*, Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses, 45 *Fed. Reg.* 81,711, at 81,712 (Dec. 11, 1980) (stating: ''If a 'separate transactions' method were not feasible, a 'net worth' method would be used to approximate a 'separate transactions' result'').

[55]Any gain or loss on assets and liabilities of the branch, whether current or noncurrent, was taken into account as profit or loss of the branch in the year in which recognized, and such profit or loss was translated into U.S. dollars using the generally applicable translation rules. Moreover, the owner was not required to recognize exchange gain or loss on distributions of previously unremitted profits, even though exchange rates could have moved between when the income was earned by the branch and when the branch remitted the earnings to the owner.

[56]Conditioning the recognition of exchange gain or loss on a branch QBU remittance, rather than on an annual mark-to-market regime as under the net worth method, or a realization- and recognition-based system as under section 988, is a timing rule and does not say anything about the owner's overall exposure to such exchange gain or loss.

[57]Section 986(b)(1).

[58]Section 986(b)(2); section 989(b)(1).

[59]Section 986(c).

[60]Section 959(a).

[61]Section 986(c).

the owner, using an approach similar to that adopted for PTI to take into account movements in the exchange rates between the time the remitted earnings actually were earned and the date the earnings actually were remitted (an earnings-only approach).[62] The conference committee, however, muddied the waters, adopting section 987(3) as it currently stands and noting in the conference committee report:

> The conference agreement generally follows the Senate amendment [which generally followed the House bill] with respect to remittances except that it is clarified that (1) any remittance of property (not just currency) will trigger exchange gain or loss inherent in *accumulated earnings or branch capital*, and (2) exchange gain or loss on remittances will be sourced or allocated by reference to the income giving rise to post-1986 accumulated earnings (generally, the residence of the qualified business unit, unless the income of the unit is derived from U.S. sources).[63] [Emphasis added.]

The brief, opaque statement — that a remittance triggers the recognition of exchange gain or loss inherent in accumulated earnings or branch capital — significantly affected the direction taken under section 987, leading policymakers to reject an earnings-only approach in favor of approaches with net worth method elements baked in.[64]

2. Foreign Exchange Exposure Pool Method

With this background, one can dissect the 2006 proposed regulations. Since section 987 was enacted in 1986, Treasury and the IRS have come out with two sets of proposed regulations, the first in 1991 and the second, which withdrew the 1991 proposed regulations and set forth the foreign exchange exposure pool method of accounting under section 987, in 2006. The approaches taken in the 1991 and 2006 proposed regulations diverge but reflect similar strains of thinking. Both the 1991 and 2006 proposed regulations adopt hybrid approaches that include translation rules intended to implement a profit or loss method of accounting,[65] and each contain net-worth-type rules for measuring and recognizing section 987 gain or loss.[66] The 1991 proposed regulations effectively exposed an owner to section 987 gain or loss on its entire investment in a section 987 QBU,[67] whereas the 2006 proposed regulations limit an owner's exposure to section 987 gain or loss on section 988-type financial assets

[62]H.R. Rep. No. 99-426, at 469-470 (1985); S. Rep. No. 99-313, at 470 (1986).

[63]Conference Committee Report, at II-674-75.

[64]Policymakers noted this language in the preamble to the 2006 proposed regulations, stating:

> Despite the broad statements [that the same translation rules would apply regardless of the form through which business was conducted, such as a partnership or corporation, contained in the legislative history], Congress provided more specific guidance regarding the treatment of branches in this regard. The Conference Report states that a remittance by a QBU ''will trigger exchange gain or loss inherent in accumulated earnings or branch capital.'' Conference Report, 1986-3 C.B. Vol. 4, 675. See [section] 601.601(d)(2). Similarly, despite the stated requirement that QBUs must use a notional profit and loss method to determine branch taxable income, the specific method actually provided in section 987 and described in the legislative history represents a blend of a net worth method and a profit and loss method. Accordingly, the IRS and the Treasury Department believe that the more specific statements made by Congress regarding the treatment of branch exchange gain or loss reflect an intention that the methodologies of section 986(c) and section 987 not be identical.

Fed. Reg., Vol. 71, No. 173, at 52,878.

[65]Regarding the profit and loss translational aspect of section 987, under the 1991 proposed regulations, the section 987 QBU's net income or loss was computed in its functional currency and then was translated into the owner's functional currency at the weighted average exchange rate for the year. Former prop. reg. section 1.987-1(b)(1)(i); former prop. reg. section 1.987-1(b)(1)(iii).

[66]Regarding the net worth exchange gain or loss aspect, the 1991 proposed regulations required an owner to maintain an equity pool and basis pool for the section 987 QBU. Former prop. reg. section 1.987-2(a)(1). The equity pool represented the section 987 QBU's undistributed earnings and the basis in its capital and was maintained in the section 987 QBU's functional currency, whereas the basis pool represented the owner's basis in its overall investment in the section 987 QBU and was maintained in the owner's functional currency. Former prop. reg. section 1.987-2(a)(1); former prop. reg. section 1.987-2(c). The balance of the equity pool was increased by the section 987 QBU's income and by contributions by the owner to the section 987 QBU, and decreased by losses and distributions from the section 987 QBU to the owner. Former prop. reg. section 1.987-2(c)(1). The balance of the basis pool similarly was increased by income and contributions and decreased by branch losses and distributions. The amount of the increase or decrease to the basis pool was determined by translating the income or loss or contribution or distribution into the owner's functional currency. Former prop. reg. section 1.987-2(c)(2)(ii)-(iii).

[67]Under the 1991 proposed regulations, the owner recognized section 987 gain or loss on a remittance of branch earnings or property based on the difference between (i) the amount of the remittance translated into the owner's functional currency at the spot exchange rate on the date of the remittance, and (ii) the portion of the owner's basis pool attributable to the remitted earnings or property. Former prop. reg. section 1.987-2(d)(1). A remittance was defined as any transfer of property from a section 987 QBU, based on a daily netting rule, but only to the extent the section 987 QBU's equity pool had a positive balance. Former prop. reg. section 1.987-2(b)(4). The portion of the basis pool attributable to the remittance equaled (i) the amount of the remittance, denominated in the section 987 QBU's functional currency, divided by (ii) the equity pool balance (before the remittance), and multiplied by (iii) the balance of the basis pool (similarly before the remittance). Former prop. reg. section 1.987-2(d)(2). Conceptually, then, a reduction in the owner's investment in the foreign branch triggers a proportional amount of the exchange gain or loss built into the owner's overall branch investment.

and liabilities held by the section 987 QBU that are denominated in the section 987 QBU's functional currency.

To implement the net worth aspect, the 2006 proposed regulations divide the assets and liabilities attributable to a section 987 QBU into two categories: marked items and historic items. Marked items are section 988-type financial assets and liabilities held by a section 987 QBU that are denominated in the section 987 QBU's functional currency. They are referred to as marked items because under the foreign exchange exposure pool method, they are marked to market annually, although the gains and losses from the marking are taken into account under a pooling and remittance mechanism.[68] Historic items are a residual category that includes any assets or liabilities that are not marked items.[69]

Regarding the profit and loss method aspect of the foreign exchange exposure pool method, subject to important exceptions, the section 987 QBU's items of income, gain, deduction, or loss are translated into the owner's functional currency using the average exchange rate for the year.[70] Regarding the net worth method aspect, the 2006 proposed regulations limit an owner's exposure to section 987 gain or loss to gain or loss that accrues on the section 987 QBU's marked items.[71] Thus, the owner is exposed to section 987 gain or loss only on assets and liabilities on which it would be subject to exchange gain or loss under section 988 if it held the assets and liabilities directly, rather than through a section 987 QBU. This approach is intended to limit the generation of noneconomic currency gains and losses,[72] and it roughly aligns an owner's exposure to section 987 gain or loss to the exposure it would have to exchange gain or loss under section 988 if the foreign branch did not qualify as a section 987 QBU (the timing, however, would not necessarily correspond).

Consistent with viewing this aspect of the foreign exchange exposure pool approach as a surrogate at the owner level for applying section 988 to the assets and liabilities held through the section 987 QBU, the section 987 QBU would not recognize exchange gain or loss under section 988 on most financial transactions denominated in the owner's functional currency.[73] This means the owner is not exposed to currency gain or

[68]An asset or liability qualifies as a marked item if (i) had the owner acquired or incurred the item directly, such transaction would be a section 988 transaction, and (ii) the section 987 QBU's acquisition or incurrence of the item is not a section 988 transaction. Prop. reg. section 1.987-1(d).

[69]Prop. reg. section 1.987-1(e).

[70]Prop. reg. section 1.987-3(b)(1). Unlike under the traditional profit and loss method and the 1991 proposed regulations, however, the section 987 QBU's bases in its historic items are translated into the owner's functional currency using the exchange rate on the date the relevant asset was acquired (the historic exchange rate), and depreciation, depletion, and amortization deductions on these historic items are translated using the historic exchange rate. Prop. reg. section 1.987-3(b)(ii)(B)(1); prop. reg. section 1.987-3(b)(2)(i).

The effect of using the historic exchange rate to translate adjusted basis and depreciation regarding historic items is that although the owner is not exposed to section 987 gain or loss on such historic items, it nonetheless takes into account income or loss attributable exclusively to movements in the exchange rate. For example, assume an owner uses the U.S. dollar as its functional currency and owns a section 987 QBU, B, which uses the *x* as its functional currency. At the beginning of year 1, on a date when the *x*/U.S. dollar exchange rate is 2 to 1, B acquires an asset for 100*x* that is depreciable over 10 years. Thus, B takes into account $5 of depreciation in year 1 (10*x* of depreciation translated into U.S. dollars at the historical exchange rate). Assume that during year 1, the *x* weakened against the dollar, so that the average exchange rate for the year is 3 to 1. B sells the asset for 100*x* at the end of year 1, taking into account $3.33 of gain (10*x* translated into U.S. dollars at the average exchange rate for the year). B's net loss related to the asset for year 1 is ($1.66), even though it had no net gain or loss in terms of *x*.

[71]The owner annually would adjust its net unrecognized section 987 gain or loss, an amount which would reflect the net accrued but not yet recognized exchange gain or loss built into the section 987 QBU's marked items. Prop. reg. section 1.987-4. The annual adjustment reflects the change during the year in the value of the marked items, which largely is a function of the movement in the exchange rate during the year. The net unrecognized section 987 gain or loss is taken into account proportionately upon a remittance (applying an annual netting rule to determine the net transfer from the section 987 QBU to the owner or other section 987 QBUs of the owner). Prop. reg. section 1.987-5. The amount of section 987 gain or loss taken into account would be determined by multiplying the balance of the foreign exchange exposure pool at the end of the year by a fraction, the numerator of which is the amount of the net remittance for the year determined in the owner's functional currency, and the denominator of which is the section 987 QBU's aggregate basis in its gross assets, again determined in the owner's functional currency. Prop. reg. section 1.987-5(b).

[72]Policymakers were concerned that the 1991 regulations imputed ''currency gain or loss to all equity of a QBU whether or not the assets of the QBU are economically exposed to the changes in the value of the functional currency of the QBU.'' *Fed. Reg.*, Vol. 71, No. 173, at 52,879.

[73]Prop. reg. section 1.987-3(e)(2). Specifically, the section 987 QBU would not recognize exchange gain or loss under section 988 on transactions denominated in the owner's functional currency that are described in section 988(c)(1)(B)(i) (acquiring or becoming an obligor on a debt instrument), section 988(c)(1)(B)(ii) (accruing a payable or receivable), or section 988(c)(1)(C) (disposing of nonfunctional currency).

A section 987 QBU's exchange gain or loss under section 988 on financial transactions denominated in a third currency, namely, a currency other than the functional currency of the owner or the section 987 QBU, however, is determined by reference to movements in the exchange rate between the third currency and the section 987 QBU's functional currency, not between the third currency and the owner's QBU's functional currency. Prop. reg. section 1.987-3(e)(1); prop. reg. section

(Footnote continued on next page.)

loss on most financial transactions denominated in its functional currency, regardless of whether the owner enters into the transaction directly or indirectly through a section 987 QBU.

B. Proposed Aggregate Approach

The 2006 proposed regulations generally adopt an aggregate approach under section 987.[74] To do this, they limit section 987's application to only certain taxpayers, namely, individuals and corporations that directly through a pure branch, or indirectly through a partnership, conduct activities that qualify as section 987 QBUs with respect to such owner.[75] Section 987 QBUs, thus, are limited to direct or indirect activities of individuals and corporations that constitute a section 989 QBU and have a different functional currency than the owner. The effect is that activities conducted by a partnership could, to the extent they otherwise satisfied the definitional requirements of a section 989 QBU, constitute a section 987 QBU of an individual or corporate partner in the partnership (an indirect section 987 QBU).[76] Whether partnership activities constitute an indirect section 987 QBU would be tested at the individual or corporate partner level by comparing the functional currency of the section 989 QBU composed of the partnership activities against the functional currencies of the individual or corporate partners.

The aggregate approach of the 2006 proposed regulations has implications for both the profit and loss and net worth aspects of the 2006 proposed regulations. Regarding the profit and loss translation aspect, a partnership determines the items of income, gain, deduction, or loss for the indirect section 987 QBU in the QBU's functional currency,[77] and then the items are allocated among the partners in accordance with their distributive shares, as determined under the generally applicable rules of subchapter K.[78] The partners adjust the indirect section 987 QBU's book items to reflect U.S. federal income tax principles, and then the adjusted items are translated directly from the indirect section 987 QBU's functional currency into the partners' respective functional currencies under the generally applicable translation rules, skipping over any translation that would be necessary to convert the indirect section 987 QBU's results into the partnership's functional currency (if different from that of the partner). This means a partnership will transmit the items of a section 987 QBU to the partners in the section 987 QBU's functional currency without first computing such items in the partnership's functional currency.

Regarding the net worth aspect, the partners would measure and take into account section 987 gain or loss under the foreign exchange exposure pool method by applying the generally applicable rules to their shares of the marked items actually owned by the indirect section 987 QBU. The partners' respective shares of the marked items of the indirect section 987 QBU would, as was the case for the determination of a partner's share of a section 988 transaction under the proposed regulations, be determined based on their shares of the economic benefits and burdens regarding such assets and liabilities, applying the principles of subchapter K.[79]

C. Entity Approach — Section 987

Like under section 988, when the functions of section 987 are considered within the generally applicable partnership tax rubric, an entity approach is more appropriate. To summarize, under an entity theory, exchange gain or loss under section 988 not attributable to a section 987 QBU of the partnership would be determined by reference to the partnership's functional currency, and section 987 would apply at the partnership level. That is, whether activities of a partnership constitute a section 987 QBU would be determined by reference to the partnership's functional currency, not the functional currencies of the partners, and the rules of section 987 would apply to the partnership because it would be the owner of the section 987 QBUs. Adopting an entity theory would raise further issues, however, such as how to translate the partnership's results into the functional currencies of its partners. These issues are addressed in Section IV.

As an initial point, as under section 988, the statutory language of section 987 suggests that Congress anticipated that an entity approach would apply. Section 987 applies to taxpayers with one or more QBUs with a functional currency other than the U.S. dollar. Thus, partnerships, as taxpayers, would fall within the scope of section 987 unless excluded by regulation. Congress's consistent use of the term ''taxpayer'' in the interrelated currency rules of sections 985, 987, and 988 suggests it intended for the provisions to apply in parallel across individuals and entities.[80] It would be odd for the term to be given a different meaning under

1.987-3(f), Example (10). Such exchange gain or loss then would need to be translated from the section 987 QBU's functional currency into the owner's functional currency under the generally applicable translation rules.

[74]The 1991 proposed regulations generally reserved on the treatment of partnerships under section 987. Former prop. reg. 1.987-2(g).

[75]Prop. reg. section 1.987-1(b)(1)(i).

[76]A de minimis rule would, however, allow partners with a less than 5 percent capital or profits interest in a partnership to elect out of section 987 with respect to indirect section 987 QBUs owned through the partnership. Prop. reg. section 1.987-1(b)(2)(1)(ii).

[77]Prop. reg. section 1.987-3(a)(2)(ii).

[78]Prop. reg. section 1.987-3(a)(2)(iii).

[79]Prop. reg. section 1.987-7(b).

[80]As discussed in Section II regarding section 988, Congress specially provided for an aggregate treatment of partnerships for limited purposes and singled out partnerships for special treatment in several instances.

section 987 than under the other currency provisions absent a compelling policy justification.

More importantly, as was the case under section 988, partnership tax principles also lead to an entity approach, because it is more appropriate for implementing both the profit and loss translational element and the net worth element of the foreign exchange exposure pool method. First, the translation rules are mere mechanical rules needed for converting nonfunctional currency-denominated tax items into functional currency-denominated tax items, a necessary step in computing taxable income or loss of the owner in its functional currency. As discussed in Section II, partnership tax principles strongly support centralized measurement and computation of income or loss from partnership activities at the partnership level, and translation of items into a taxpayer's functional currency falls squarely within that purview. Taxable income or loss of a partnership must be computed as if the partnership were an individual, subject to specified modifications.[81] Failing to translate the results of a section 987 QBU composed of a partnership's activities into the partnership's functional currency, as would be the case under the 2006 proposed regulations with respect to indirect section 987 QBUs, would be flatly inconsistent with this fundamental principle of partnership taxation, and it would severely undercut, in the case of partnerships, the principle under section 985 that a taxpayer generally determines its tax items in its functional currency.[82]

An entity approach also is more appropriate for implementing the net worth aspect of the foreign exchange exposure pool method. As explained herein, this aspect of the method is a surrogate for applying section 988 at the owner level to transactions undertaken through a section 987 QBU. The owner's overall exposure to section 987 gain or loss roughly matches the exposure to exchange gain or loss the owner would have under section 988 if it held the marked items directly, rather than through the section 987 QBU. If one accepts the argument proffered in Section II that an entity approach should apply under section 988 because the partnership tax principles require rules of measurement, computation, and characterization to apply at the partnership level, it should follow that the net worth aspect of section 987 also would apply at the partnership level for the same reasons.[83] Otherwise, sections 988 and 987 would be at odds and would not operate as substitutes.

Finally, the same administrative problems an aggregate approach raises under section 988 — namely, that partners lack timely access to the information needed to make determinations and computations regarding partnership transactions and that principle-based methods of allocating partnership assets and liabilities do not lend themselves to the precise determinations required — are present to an even greater degree under section 987.[84] Simply put, it seems unrealistic to assume partners, particularly minority partners, could satisfactorily administer an aggregate approach if the foreign exchange exposure pool method were adopted.

It would be understandable for policymakers to buck the general partnership tax principles that measurement and computation of the tax consequences of partnership transactions be done at the partnership level if applying an entity approach under section 988 or 987 would open the door to abuse. That should not be the case, though. While it is true that adopting an entity approach would create disparity between the treatment under the currency rules of pure branches (such as a sole proprietorship or division of a corporation) and the treatment of partnership interests, this disparity certainly would not be unique to the currency rules. Moreover, regardless of whether an aggregate or entity approach is adopted, disparity would be created between the currency treatment of partnerships and other forms of doing business; if an aggregate approach applies, disparity is created between the treatment of partners and partnerships and the treatment of shareholders and corporations. Thus, the potential for disparity should not tip the scales, and the determination should be made based on established partnership tax guideposts.

Perhaps the more important point is that if policymakers are concerned that the disparate treatment of partnerships and pure branches could lead to abuses, these potential abuses could (and should) be policed with more targeted rules.[85] For example, one could imagine limitations on a partnership's ability to use a functional currency different from those of its partners in situations involving potentially abusive facts, such as

[81] *See* section 703(a).

[82] *See* section 985(a).

[83] The same partnership tax policies that support applying section 988 at the partnership level equally support an entity approach regarding the net worth aspect of section 987. The purpose of recognizing section 987 gain or loss is to measure properly the taxable income or loss of the owner in terms of a single, uniform unit of account. Marked items, just like section 988 transactions, derive their status as such by reference to the functional currency of the owner. The functional currency of the owner is, in the case of a section 988 QBU with a functional currency other than the U.S. dollar, determined in part by reference to the location and nature of the business activities of the owner. As discussed in Section II, partnership tax principles generally require characterization determinations to be made at the partnership level, particularly where they are based on business activities.

[84] *See* "NYSBA Members Comment on Proposed Branch Currency Transaction Regs," *Doc 2008-149*, *2008 WTD 4-22* (Jan. 4, 2008); "AICPA Seeks Reconsideration of Proposed Branch Currency Transaction Regs," *Doc 2007-8913*, *2007 WTD 68-15* (Apr. 6, 2007); ABA Section of Taxation, Comments on Proposed Regulations Under Section 987 (Feb. 24, 2010), at 21-22.

[85] *See* ABA Section of Taxation, *supra* note 84, at 22.

if one of the partners held virtually all of the capital or profits interests in the partnership. Potential abuses might, in fact, already be addressed sufficiently by existing rules and doctrines. The partnership antiabuse rules of reg. section 1.701-2 come to mind as one set of rules that might adequately address any concerns.

IV. Further Considerations

Adopting an entity approach under sections 987 and 988 would raise collateral questions. One question is whether the elements of section 987 also should apply at the partner level, with the partnership treated as a section 987 QBU with respect to the partners that use different functional currencies than the partnership.

The better view appears to be that section 987 should not be applied at the partner level with respect to the partnership. It would not make sense to apply the net worth aspect of section 987 again on financial assets and liabilities held by the partnership. This would result in the partners measuring exchange gain or loss twice — first, directly at the partnership level based on the partnership's functional currency and, second, indirectly at the partner level based on the partner's functional currency — on some of the same assets and liabilities. As described in Section II, section 988 is most appropriately applied to partnership transactions at the partnership level, and only at the partnership level, under generally applicable partnership tax principles, and as explained in Section III, the net worth aspect of section 987 acts as a substitute for, and should be implemented consistently with, section 988.

Similarly, it is hard to see the logic behind applying the full-blown profit and loss translational aspect of the 2006 proposed regulations at the partner level with respect to partnership tax items. Those tax items already would have been collected and measured under the rules of subchapter K at the partnership level and denominated in the partnership's functional currency under the rules of subchapter J.[86] Applying the profit and loss aspect at the partner level would require unpacking those amounts and recomputing the items one at a time in the partner's functional currency.

Nonetheless, it would be necessary to translate the partner's share of the partnership's items, including the separately stated items, into the partner's functional currency (if different from that of the partnership) for the partner to compute its own tax liability. It seems most consistent with the translation rules of section 989 for the partners to translate the partnership's general income or loss and its separately stated items into the partners' respective functional currencies using the average exchange rate for the partnership's tax year.[87] This would create parity between the translation rules for a partner's distributive share of partnership income and a U.S. shareholder's share of a CFC's subpart F income,[88] which effectively is taxed on a passthrough basis.

The somewhat harder question would be whether the partners should recognize currency gain or loss on an actual distribution by the partnership out of income already taken into account by the partners for tax purposes to reflect movements in the relevant exchange rates, as is required upon a distribution of PTI by a CFC.[89] The parallels between passthrough taxation and the operation of subpart F suggest it might be appropriate. A partner would recognize either more or less economic gain than it previously took into account for tax purposes upon receiving the actual distribution of profits from the partnership, depending on whether the functional currency of the partnership appreciated or depreciated compared with the functional currency of the partner between the time the income was taken into account for tax purposes and the time of the distribution. The currency treatment of PTI distributions, then, would appear to serve as a model for the currency treatment of partnership distributions.[90] The immediate counterargument would be that Congress expressly authorized this result for PTI in section 986(c) and made no similar authorization regarding distributions of partnership profits. ◆

[86] To the extent the items were attributable to section 987 QBUs of the partnership, they would have been translated into the partnership's functional currency at the exchange rate required under section 987 (whether the average exchange rate for the year or the historical exchange rate).

[87] *See* section 989(b)(4). This would be consistent with Congress's intent to harmonize the translational rules applicable for taxpayers undertaking business through different forms. *See* H.R. Rep. No. 99-426 (1985), at 479, footnote 49a (''These translation rules will apply regardless of the form of enterprise (e.g., sole proprietorship, partnership, or corporation) through which the taxpayer conducts its business, provided at least one qualified business unit of the taxpayer uses a functional currency other than the dollar''); JCT General Explanation, *supra* note 21, at 1108 (''Any entity that uses a nonfunctional currency is required to measure the untranslated results of operation under a profit and loss method, and to translate income or loss into the functional currency at a prescribed ('appropriate') exchange rate for the year. . . . These translation rules apply without regard to the form of enterprise through which the taxpayer conducts business (e.g., sole proprietorship, partnership, or corporation), as long as the enterprise rises to the level of a QBU'').

[88] *See* section 989(b)(3).

[89] *See* section 986(c).

[90] *See generally* Notice 88-71, 1988-2 C.B. 374 (requiring taxpayers to allocate dollar basis to distributed PTI using a pooling approach); prop. reg. section 1.959-3(b) (permitting a taxpayer either to maintain annual PTI and dollar basis accounts and trace distributions of PTI to particular years on a last-in, first-out basis, or to pool the dollar basis of all its PTI).