

Tax Accounting Quarterly Update - March 2025

Teaser Video Transcript

Foreign Exchange Gains

This is just a picture on a page to illustrate when and why the rules are relevant. And as you'll see on the right, most a most common structure, if you've got a taxpayer at the top and then underneath that a foreign branch or a foreign disregarded entity. And we're looking for the scenarios where there's going to be a remittance or a payment made in the future from those. And you'll see on the left that just in this particular scenario, you'll see that the owner and the foreign disregarded entity each have a different functional currency. So if you see that on an 8858, which you may well have seen in your tax returns, think, oh, actually searching 987 may well be relevant here in terms of the, these actual specific regulations and how they work.

I'm not going to go into the, the, the full 10 step approach in detail because it's very complex. But what I wanted to convey here is, is, is what it is trying to do. So it's around what we call the foreign exchange exposure pool method, the feet method. If you have feet, that's what it's referring to. First proposed in 2006, I guess that's a long time. And what the 10 step method generally does is it compares your end of year versus your beginning of year net assets using specific exchange rate rules. And then what it tries to do is through 10 steps, it eliminates the impact of certain events such as contributions made during the year, such as profit made in the year for the DRE.

And it tries to eliminate the impact of them to effectively isolate what part of that is foreign exchange related. It's worth bearing in mind that the really the tricky thing about these rules is that it puts your assets into different baskets. Some are called marked items, some are historic items and particularly for historic items, things like land or buildings, you would have to track the rates when the expenditure was initially incurred, you know kind of an asset by asset issue and that obviously could be a big compliance burden and we'll need to think about whether the data is available for that. So just to summarize the final considerations for Section 987, as you see on the page I mentioned before we need to make adjustments to get ourselves within this method going forward.

And this is the pre-transition gain or loss. We've got some clients who have previously had what I'm going to call a good methodology or an eligible method for 987 purposes such as under the 1991 regs and those may fall more easily and be able to transition more easily into the new rules. But for clients that haven't got this in place or maybe they haven't consistently adopted a method, they may need to go through an exercise to calculate what that pre-transition gain or loss is. And this could go back potentially as far back as 2006. The final point I'd just like to point out is that even though the rules are complex, there are elections that can be made which either might help from a tax perspective or may simplify the rules significantly.

So things like you'll see on the page here, the current rate election is an election which effectively will help you. We avoid the historic item tracking that I mentioned before and the amortization election may be something helpful if you're anticipating a loss on the way into the rules because it may allow you to spread that loss over 10 years. So although a compliance burden, some of these rules may yield quite a good tax answer. So it's definitely one to consider from both angles there.