U.S. DEPARTMENT OF THE TREASURY

Second Report to the President on

Identifying and Reducing Tax Regulatory Burdens

Executive Order 13789

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Introduction

This Second Report recommends actions to eliminate, and in other cases mitigate, consistent with law, the burdens imposed on taxpayers by eight regulations that the Department of the Treasury (Treasury) has identified for review under Executive Order 13789. As stated in the order, it is the policy of the President that tax regulations provide clarity and useful guidance. Recent regulations, however, have increased tax burdens and impeded economic growth. The order therefore calls for immediate action to reduce tax regulatory burdens and provide useful and simplified tax guidance.

The order directed the Secretary of the Treasury to identify significant tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the Internal Revenue Service (IRS). In an interim Report to the President dated June 22, 2017 (the "June 22 Report"), Treasury identified eight such regulations. Executive Order 13789 further directs the Secretary to submit to the President a report recommending "specific actions to mitigate the burden imposed by regulations identified in the interim report."

This Second Report sets forth the Secretary's recommendations. Treasury expects to issue additional reports on reducing tax regulatory burdens, including, as directed in the order, the status of Treasury's actions recommended in this Second Report.

Treasury Department Retrospective Regulatory Review

Treasury is committed to reducing complexity and lessening the burden of tax regulations. In response to Executive Order 13789, Treasury's Office of Tax Policy completed a comprehensive review of all tax regulations issued in 2016 and January 2017. The June 22 Report identified eight proposed, temporary, or final regulations for withdrawal, revocation, or modification. Treasury continues to analyze all recently issued significant regulations and is considering possible reforms of several recent regulations not identified in the June 22 Report. These include regulations under Section 871(m), relating to payments treated as U.S. source dividends, and the Foreign Account Tax Compliance Act.

In addition, in furtherance of the policies stated in Executive Order 13789, Executive Order 13771, and Executive Order 13777,[1] Treasury and the IRS have initiated a comprehensive review, coordinated by the Treasury Regulatory Reform Task Force, of all tax regulations, regardless of when they were issued. Thus, most of the regulations subject to this review predate January 1, 2016. This review will identify tax regulations that are unnecessary, create undue complexity, impose excessive burdens, or fail to provide clarity and useful guidance, and Treasury and the IRS will pursue reform or revocation of those regulations. Included in the review are longstanding temporary or proposed regulations that have not expired or been finalized. As part of the process coordinated by the Treasury Regulatory Reform Task Force, the IRS Office of Chief Counsel has already identified over 200 regulations for potential revocation, most of which have been outstanding for many years. These regulations remain in the Code of Federal Regulations (CFR)

1. Executive Order 13771, titled "Reducing Regulation and Controlling Regulatory Costs," manages the costs associated with the regulatory compliance by, among other things, generally requiring the identification of two regulations for repeal for every new regulation that is proposed. Executive Order 13777, titled "Enforcing the Regulatory Reform Agenda," sets forth procedures for implementing and enforcing regulatory reform.

but are, to varying degrees, unnecessary, duplicative, or obsolete, and force taxpayers to navigate unnecessarily complex or confusing rules.[2] Treasury and the IRS expect to begin the rulemaking process for revoking these regulations in the fourth quarter of 2017. Treasury and the IRS are also seeking to streamline rules where possible. Later reports and guidance will provide details on the regulations identified for possible action, the reasons that they may be revoked, and the manner in which revocation would occur.

Treasury has considered carefully the burdens that the eight regulations identified in the June 22 Report impose and, in conjunction with the IRS Office of Chief Counsel, has extensively studied possible actions to provide relief. In response to a public request for comments following the June 22 Report, Treasury received over 140 comments from the public – as well as thousands of duplicate form comments – concerning the potential modification or revocation of the eight regulations identified.[3] The thrust of the comments varied widely, with some recommending that Treasury withdraw one or more of the regulations and others requesting that Treasury retain those same regulations. Treasury has carefully reviewed and considered the comments and possible reforms. One specific action – guidance delaying the documentation regulations under Section 385 – has already been taken by the IRS in Notice 2017-36. As described below, Treasury now recommends, consistent with law, that two proposed regulations be withdrawn entirely, three temporary or final regulations be revoked in substantial part, and the remaining three regulations all be substantially revised.

Proposed Regulations to be Withdrawn Entirely

1. Proposed Regulations under Section 2704 on Restrictions on Liquidation of an Interest for Estate, Gift and Generation-Skipping Transfer Taxes

(REG-163113-02; 81 F.R. 51413)

Section 2704 addresses the valuation, for wealth transfer tax purposes, of interests in family-controlled entities. In limited cases, Section 2704 disregards restrictions on the ability to liquidate family-controlled entities when determining the fair market value of an interest for estate, gift, and generation-skipping transfer tax purposes. Also in limited cases, Section 2704 treats lapses of voting or liquidation rights as if they were transfers for gift and estate tax purposes. The proposed regulations, through a web of dense rules and definitions, would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded under Section 2704. In addition, the proposed regulations would have required an entity interest to be valued as if disregarded restrictions did not exist, either in the entity's governing documents or under state law. No exceptions would have been allowed for interests in active or operating businesses.

The goal of the proposed regulations was to counteract changes in state statutes and developments in case law that have eroded Section 2704's applicability and facilitated the use of family-controlled entities to generate artificial valuation discounts, such as for

2. *See* Executive Order 13777 § 3(f) (directing "each agency head [to] prioritize" revocation of regulations which are "outdated, unnecessary, or ineffective").

3. Comments can be found at the following website: *https://www.regulations.gov/docketBrowser?rpp=25&so=DESC&sb=commentDueDate&po=0&dct=PS&D=IRS-2017-0012*

lack of control and marketability, and thereby depress the value of property for gift and estate tax purposes. Commenters warned, however, that the valuation requirements of the proposed regulations were unclear and that their effect on traditional valuation discounts was uncertain. In particular, commenters argued that it was not feasible to value an entity interest as if no restrictions on withdrawal or liquidation existed in either the entity's governing documents or state law. A legal vacuum in which there is no law relevant to an interest holder's right to withdraw or liquidate is impossible, commenters asserted, and, therefore, cannot meaningfully be applied as a valuation assumption. Commenters also argued that the proposed regulations could have produced unrealistic valuations. For example, the lack of a market for interests in family-owned operating businesses is a reality that, commenters argued, should continue to be taken into account when determining fair market value.

After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it is unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts. Moreover, merely to reach the conclusion that an entity interest should be valued as if restrictions did not exist, the proposed regulations would have compelled taxpayers to master lengthy and difficult rules on family control and the rights of interest holders. The burden of compliance with the proposed regulations would have been excessive, given the uncertainty of any policy gains. Finally, the proposed regulations could have affected valuation discounts even where discount factors, such as lack of control or lack of a market, were not created artificially as a value-depressing device.

In light of these concerns, Treasury and the IRS currently believe that these proposed regulations should be withdrawn in their entirety. Treasury and the IRS plan to publish a withdrawal of the proposed regulations shortly in the Federal Register.

2. Proposed Regulations under Section 103 on Definition of Political Subdivision

(REG-129067-15; 81 F.R. 8870)

Section 103 excludes from a taxpayer's gross income the interest on state or local bonds, including obligations of political subdivisions. Proposed regulations would have required a "political subdivision" to possess not only significant sovereign power, but also to meet enhanced standards to show a governmental purpose and governmental control. Some commenters argued that settled law only requires a political subdivision to possess sovereign powers. Many commenters also argued that the proposed regulations would force costly and burdensome changes in entity structure to meet the new requirements. Treasury and the IRS continue to believe that some enhanced standards for qualifying as a political subdivision may be appropriate. After careful consideration of the comments on the proposed regulations, however, Treasury and the IRS now believe that regulations having as far-reaching an impact on existing legal structures as the proposed regulations are not justified.

Thus, while Treasury and the IRS will continue to study the legal issues relating to political subdivisions, Treasury and the IRS currently believe that these proposed regulations should be withdrawn in their entirety, and plan to publish a withdrawal of the proposed regulations shortly in the Federal Register. Treasury and the IRS may propose more targeted guidance in the future after further study of the relevant legal issues.

Regulations to Consider Revoking in Part

3. Final Regulations under Section 7602 on the Participation of a Person Described in Section 6103(n) in a Summons Interview (T.D. 9778; 81 F.R. 45409)

These final regulations provide that the IRS may use private contractors to assist the IRS in auditing taxpayers. Under the regulations, the IRS may contract with persons who are not government employees, and those private contractors may "participate fully" in the IRS's interview of taxpayers or other witnesses summoned to provide testimony during an examination. In particular, the regulations allow private contractors to receive and review records produced in response to a summons, be present during interviews of witnesses, and question witnesses under oath, under the guidance of an IRS officer or employee. These regulations were issued as temporary regulations in 2014 and were finalized in 2016.

Although only two comments were submitted during the public comment period, these regulations have since attracted public attention and criticism. In particular, the IRS's ability to hire outside attorneys as contractors and have them question witnesses during a summons interview has raised concerns. After the IRS hired an outside law firm to assist with the audit of a corporate taxpayer, a federal court found that the "idea that the IRS can 'farm out' legal assistance to a private law firm is by no means established by prior practice" and noted that it "may lead to further scrutiny by Congress."[4] While the court determined, based on the statute, that the IRS had the legal authority to enlist the outside attorneys, the court was "troubled by [the law firm's] level of involvement in this audit."[5] The Senate Finance Committee subsequently approved legislation that would prohibit the IRS from using any private contractors for any purpose in summons proceedings. This legislation has not been enacted into law.

After reviewing and considering the foregoing concerns and the public comments received, Treasury and the IRS are looking into proposing a prospectively effective amendment to these regulations in order to narrow their scope by prohibiting the IRS from enlisting outside attorneys to participate in an examination, including a summons interview. Under the amendment currently contemplated by Treasury and the IRS, outside attorneys would not be permitted to question witnesses on behalf of the IRS, nor would they be permitted to play a behind-the-scenes role, such as by reviewing summoned records or consulting on IRS legal strategy.

When the IRS enlists outside attorneys to perform the investigative functions ordinarily performed by IRS employees, the government risks losing control of its own investigation.

4. *United States v. Microsoft Corp.*, 154 F. Supp. 3d 1134, 1143 (W.D. Wash. 2015).
5. *Id.*

IRS investigators wield significant power to question witnesses under oath, to receive and review books and records, and to make discretionary strategic judgments during an audit—with potentially serious consequences for the taxpayer. The current regulation requires the IRS to retain authority over important decisions, but the risk of a private attorney taking practical control may simply be too great. These powers should be exercised solely by government employees committed to serve the public interest, not by outside attorneys. These concerns outweigh any countervailing need for the IRS to contract with outside attorneys. Treasury remains confident that the core functions of questioning witnesses and conducting investigations are well within the expertise and ability of the IRS's dedicated attorneys and examination agents.

Although Treasury and the IRS are currently considering proposing an amendment to the regulations so that outside lawyers would no longer be allowed to participate in an examination, Treasury and the IRS currently intend that the regulations would continue to allow outside subject-matter experts to participate in summons proceedings. In certain highly complex examinations, effective tax administration may require the specialized knowledge of an economist, an engineer, a foreign attorney who is a specialist in foreign law, or other subject-matter experts. In some cases, there is a compelling need to look outside the IRS for expertise that the IRS's own employees lack. Because experts have a circumscribed role in providing subject-matter knowledge, outside experts do not pose the same risks as outside attorneys. Outside experts should thus continue to be permitted to assist IRS by reviewing summoned materials and, if necessary, by posing questions to witnesses under the guidance and in the presence of IRS employees. Such a role would be limited to the small subset of cases in which the IRS requires the assistance of a subject-matter expert to ensure effective tax administration.

4. Regulations under Section 707 and Section 752 on Treatment of Partnership Liabilities (T.D. 9788; 81 F.R. 69282)

These partnership tax regulations include: (i) proposed and temporary regulations governing how liabilities are allocated for purposes of disguised sale treatment; and (ii) proposed and temporary regulations for determining whether so-called bottom-dollar" guarantees create the economic risk of loss necessary to be taken into account as a recourse liability.

The first rule would have changed the tax treatment of forming many partnerships. In particular, for disguised sale purposes, the temporary regulations would, in general terms, have applied the rules relating to non-recourse liabilities to formations of partnerships involving recourse liabilities. According to commenters, the first rule was promulgated without adequate consideration of its impact. While Treasury and the IRS believe that the temporary regulations' novel approach to addressing disguised sale treatment merits further study, Treasury and the IRS agree that such a far-reaching change should be studied systematically. Treasury and the IRS, therefore, are considering whether the proposed and temporary regulations relating to disguised sales should be revoked and the prior regulations reinstated.

By contrast, Treasury and the IRS currently believe that the second set of regulations relating to bottom-dollar guarantees should be retained. Before the proposed and temporary

regulations relating to bottom-dollar guarantees were issued, the liability allocation rules permitted sophisticated taxpayers to create basis artificially and thereby shelter or defer income tax liability. Bottom-dollar guarantees permitted taxpayers to achieve these results without meaningful economic risk, which is inconsistent with the economic-risk-of-loss principle underlying the debt allocation rules for recourse obligations. Thus, Treasury and the IRS continue to believe, consistent with the views of a number of commentators, that the temporary regulations on bottom-dollar guarantees are needed to prevent abuses and do not meaningfully increase regulatory burdens for the taxpayers affected. Consequently, although Treasury and the IRS will continue to study the technical issues and consider comments, they do not plan to propose substantial changes to the temporary regulations on bottom-dollar guarantees. Treasury and the IRS are reviewing and considering ways to rationalize and lessen the burden of partnership tax regulations governing liabilities and allocations more generally. In their review, Treasury and the IRS will take into account the ways in which the rules under different sections of the Internal Revenue Code interact, and may propose further changes to the relevant liability or allocation regulations.

5. Final and Temporary Regulations under Section 385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness (T.D. 9790; 81 F.R. 72858)

These final and temporary regulations address the classification of related-party debt as debt or equity for U.S. federal income tax purposes. Treasury received a very large number of comments on the Section 385 regulations. Many supported the regulations, while others were critical.

The regulations are primarily comprised of (i) rules establishing minimum documentation requirements that ordinarily must be satisfied in order for purported debt obligations among related parties to be treated as debt for federal tax purposes (the "documentation regulations"); and (ii) rules that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result (the "distribution regulations"). Although they each address debt/equity considerations, these two parts of the overall Section 385 regulations are very different in purpose, scope and application. The documentation rules apply principally to domestic issuers and are generally concerned with establishing certain minimum standards of practice so that the tax character of an interest can be objectively evaluated. The distribution regulations, on the other hand, principally affect interests issued to related-party non-U.S. holders and are the rules that limit earnings-stripping, including in the context of inversions and foreign takeovers. Consistent with these fundamental differences, Treasury and the IRS currently plan to take different approaches to the two parts of these regulations.

Potential revocation of documentation regulations. Many commenters strongly criticized the compliance burdens that those regulations imposed. Others urged that the regulations be retained. Several commenters argued that the burden imposed by the documentation regulations would be severe for all similarly situated taxpayers, and would exceed the perceived benefits for tax administration. Treasury and the IRS now agree with commenters that some requirements of the documentation regulations departed substantially from current practice and would have compelled corporations to build expensive new systems to satisfy the numerous tests required by the regulations. Treasury and the IRS do not believe that taxpayers

should have to expend time and resources designing and building systems to comply with rules that may be modified to alleviate undue burdens of compliance. Accordingly, shortly after issuing the June 22 Report, Treasury and the IRS announced in Notice 2017-36 that application of the documentation rules would be delayed until 2019.

After further study of the documentation regulations, Treasury and the IRS are considering a proposal to revoke the documentation regulations as issued. Treasury and the IRS are actively considering the development of revised documentation rules that would be substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations, while requiring sufficient legal documentation and other information for tax administration purposes. In place of any revoked regulations, Treasury and the IRS would develop and propose streamlined documentation rules, with a prospective effective date that would allow time for comments and compliance. Consideration is being given, in particular, to modifying significantly the requirement, contained in the documentation regulations, of a reasonable expectation of ability to pay indebtedness. This aspect of the documentation regulations proved particularly problematic. The treatment of ordinary trade payables under the documentation regulations is also being reexamined. It is also expected that any proposed streamlined documentation rules would include certain technical, conforming changes to the definitional provisions of the Section 385 regulations.

Distribution regulations retained pending enactment of tax reform. The distribution regulations address inversions and takeovers of U.S. corporations by limiting the ability of corporations to generate additional interest deductions without new investment in the United States. In recent years, earnings-stripping by foreign-parented multinational corporations, as well as corporate inversions whereby U.S. corporations become foreign corporations and engage in earnings stripping, frequently as a tax artifice, have put U.S. corporations at a competitive disadvantage compared to their foreign peers. Treasury is committed to the Administration's goals of leveling the playing field for U.S. businesses, so that they may compete freely and fairly in the global economy, and implementing tax rules that reduce the distortion of capital and ownership decisions through earnings stripping and similar practices.

Commenters have criticized the complexity and breadth of the distribution rules. They criticized in particular the funding rule that addresses multiple-step transactions and the burdens of tracking multiple transactions among affiliated companies over long periods of time. Treasury understands that the distribution rules are a blunt instrument for accomplishing their tax policy objectives, and continues to consider how the distribution rules might be made more targeted and compliance with the regulations made less onerous. At the same time, Treasury continues to believe firmly in maintaining safeguards against earnings-stripping and diminishing incentives for inversions and foreign takeovers.

Treasury has consistently affirmed that legislative changes can most effectively address the distortions and base erosion caused by excessive earnings stripping, as well as the general tax incentives for U.S. companies to engage in inversions. Treasury is actively working with Congress on fundamental tax reform that should prevent base erosion and fix the structural deficiencies in the current U.S. tax system. Tax reform is expected to obviate the need for the distribution regulations and make it possible for these regulations to be revoked.

In the meantime, after careful consideration, Treasury believes that proposing to revoke the existing distribution regulations before the enactment of fundamental tax reform, could make existing problems worse. If legislation does not entirely eliminate the need for the distribution regulations, Treasury will reassess the distribution rules and Treasury and the IRS may then propose more streamlined and targeted regulations.

Regulations to Consider Substantially Revising

6. Final Regulations under Section 367 on the Treatment of Certain Transfers of Property to Foreign Corporations (T.D. 9803; 81 F.R. 91012)

Section 367 of the Internal Revenue Code generally imposes immediate or future U.S. tax on transfers of property (tangible and intangible) to foreign corporations, subject to certain exceptions, including an exception for certain property transferred for use in the active conduct of a trade or business outside of the United States. Prior regulations provided favorable treatment for foreign goodwill and going concern value. To address difficulties in administering these exceptions, these regulations eliminated the ability of taxpayers to transfer foreign goodwill and going-concern value to a foreign corporation without immediate or future U.S. income tax. However, no active trade or business exception was provided for such transfers. Commenters noted that the legislative history to Section 367 indicated that Congress anticipated that outbound transfers of foreign goodwill and going-concern value would generally not be subject to Section 367. Some commenters requested, if the regulations were not revoked, that transfers of foreign goodwill and going-concern value be made eligible for the active trade or business exception in circumstances not ripe for abuse.

After considering the comments and studying further the legal and policy issues, Treasury and the IRS have concluded that an exception to the current regulations may be justified by both the structure of the statute and its legislative history. Thus, to address taxpayers' concerns about the breadth of the regulations, the Office of Tax Policy and IRS are actively working to develop a proposal that would expand the scope of the active trade or business exception described above to include relief for outbound transfers of foreign goodwill and going-concern value attributable to a foreign branch under circumstances with limited potential for abuse and administrative difficulties, including those involving valuation. Treasury and the IRS currently expect to propose regulations providing such an exception in the near term.

7. Temporary Regulations under Section 337(d) on Certain Transfers of Property to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) (T.D. 9770; 81 F.R. 36793)

These temporary regulations amend existing rules on transfers of property by C corporations to REITs and RICs generally. In addition, the regulations provide rules relating to newly-enacted provisions of the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"). The PATH Act's provisions were intended to prevent certain spinoff transactions involving transfers of property by C corporations to REITs from qualifying for non-recognition treatment. Commenters criticized several aspects of the regulations. According to commenters, for

example, the REIT spin-off rules could result in over-inclusion of gain in certain situations, particularly where a large corporation acquires a small corporation that engaged in a Section 355 spin-off and the large corporation subsequently makes a REIT election.

Treasury and the IRS agree that the temporary regulations may produce inappropriate results in some cases. In particular, Treasury and the IRS agree, for example, that the regulations may cause too much gain in certain cases to be recognized. Thus, Treasury and the IRS are considering revisions that would limit the potential taxable gain recognized in situations in which, because of the application of the predecessor and successor rule in Regulation Section 1.337(d)-7T(f)(2), gain recognition is required in excess of the amount that would have been recognized if a party to a spin-off had directly transferred assets to a REIT. In a case in which a smaller corporation that is party to a spin-off merges into a larger corporation in a tax-free reorganization, and the larger corporation makes a REIT election after the spin-off, the temporary regulations require immediate gain recognition with respect to all of the assets of the larger corporation. The proposed revisions under consideration by Treasury would substantially reduce the immediately taxed gain of the larger corporation by limiting gain recognition to the assets of the smaller corporation. In addition, other technical changes to narrow further the application of the rules are currently being considered. With these contemplated changes incorporated, Treasury and the IRS believe the revised regulations would more closely track the intent of Congress.

8. Final Regulations under Section 987 on Income and Currency Gain or Loss With Respect to a Section 987 Qualified Business Unit (T.D. 9794; 81 F.R. 88806)

These final regulations provide rules for: (i) translating income from branch operations conducted in a currency different from the branch owner's functional currency into the owner's functional currency; (ii) calculating foreign currency gain or loss with respect to the branch's financial assets and liabilities; and (iii) recognizing such foreign currency gain or loss when the branch makes certain transfers of any property to its owner. Commenters argued that the transition rule in the final regulations imposes an undue financial burden because it disregards losses calculated for years prior to the transition but not previously recognized. Many taxpayers have also commented that the method prescribed by the final regulations for calculating foreign currency gain or loss is unduly complex and financially burdensome to apply, particularly where the final regulations differ from financial accounting rules.

After reviewing these comments and meeting with a significant number of affected taxpayers in different industries, Treasury and the IRS believe that the regulations have proved difficult to apply for many taxpayers. To address these difficulties, Treasury and the IRS currently expect to issue guidance that would permit taxpayers to elect to defer the application of Regulation Sections 1.987-1 through 1.981-10 until at least 2019, depending on the beginning date of the taxpayer's taxable year.

In addition, Treasury and the IRS also intend to propose modifications to the final regulations to permit taxpayers to elect to adopt a simplified method of calculating Section 987 gain and loss and translating Section 987 income and loss, subject to certain limitations on the timing of recognition of Section 987 loss. Under one variation of a simplified methodology currently being considered, taxpayers would treat all assets and liabilities of a Section 987

qualified business unit (QBU) as marked items and translate all items of income and expense at the average exchange rate for the year. This methodology generally would result in determinations of amounts of Section 987 gain or loss that are consistent with amounts of translation gain or loss that would be determined under applicable financial accounting rules, as well as under the 1991 proposed Section 987 regulations.

In this connection, the IRS and the Office of Tax Policy are considering alternative loss recognition timing limitations that would apply to electing taxpayers. Under the base limitation under consideration, the electing taxpayer would be permitted to recognize net Section 987 losses only to the extent of net Section 987 gains recognized in prior or subsequent years. As a possible additional approach to limiting losses, the IRS and the Office of Tax Policy are also considering the administrability of a limitation under which the electing taxpayer would defer recognition of all Section 987 losses and gains until the earlier of (i) the year that the trade or business conducted by the Section 987 QBU ceases to be performed by any member of its controlled group or (ii) the year substantially all of the assets and activities of the QBU are transferred outside of the controlled group.

Finally, the IRS and the Office of Tax Policy are considering alternatives to the transition rules in the final regulations. One alternative would be to allow taxpayers that elect to apply the loss limitations applicable to the simplified methodology discussed above to carry forward unrealized Section 987 gains and losses, measured as of the transition date with appropriate adjustments, and subject to such loss limitations. A second alternative under consideration would be to allow taxpayers adopting the final regulations to elect to translate all items on the QBU's opening balance sheet on the transition date at the spot exchange rate, but not carry forward any unrealized Section 987 gains or losses.