



NEW FINAL REGS. ON  
**TRIGGER**  
EVENTS  
FOR RECAPTURE OF DUAL CONSOL

The IRS determined that the intended reduction in administrative burden could be accomplished by eliminating the closing agreement requirement in the situations specified in the Proposed Regulations while retaining the requirement to file a new -2(g)(2) Election.

**LEWIS J. GREENWALD AND ROBERT J. LeDUC**



# ING

## IDENTIFIED LOSSES

**A** “dual resident corporation” (as defined below) can be a member of both a foreign and a domestic consolidated group. Prior to the enactment of Section 1503(d) in 1986, if such a corporation

had a “dual consolidated loss” (also as defined below), it could use that loss to offset the income of both its domestic and foreign affiliates. Congress determined that the use of losses in two taxing jurisdictions was inappropriate and enacted Section 1503(d) to police this abuse.<sup>1</sup> As discussed below, Section 1503(d) provides that a dual consolidated loss (DCL) cannot, except in certain circumstances, be allowed to reduce the taxable income of any other member of the U.S. affiliated group.

The Regulations, however, permit a taxpayer to elect to use a DCL to offset the income of a domestic affiliate by entering into an agreement under which the taxpayer certifies that the DCL has not been, and will not be, used to offset the income of another person under the laws of a foreign country (commonly referred to as a “-2(g)(2) Election” from the relevant Reg. 1.1503-2(g)(2)). If certain “triggering events” occur, the taxpayer is required to include the previously deducted loss in income and pay an interest charge to recapture the value of the tax deferral.<sup>2</sup> Under certain circumstances, a triggering event could be avoided if a closing agreement was entered into with the IRS and a new -2(g)(2) Election was filed.<sup>3</sup>

On July 31, 2002, in an effort to reduce taxpayers’ administrative burden, the IRS issued Proposed Regulations that would have eliminated the closing agreement and new -2(g)(2) Election in two specific situations.<sup>4</sup> The Proposed Regulations were finalized in modified form on July 29, 2003, and are retroactively effective for transactions entered into after December 31, 2001.<sup>5</sup>

## Background

A corporation that is created or organized in the U.S. or under the laws of the U.S. or any state is treated as a

*LEWIS J. GREENWALD is a partner, and ROBERT J. LeDUC is an associate, with Sullivan & Worcester LLP. Mr. Greenwald is a frequent contributor to THE JOURNAL.*



“domestic corporation” for U.S. federal tax purposes.<sup>6</sup> The U.S. generally taxes domestic corporations on their worldwide income and allows them to deduct losses wherever incurred. The U.S. also generally allows commonly owned domestic corporations to file a consolidated return with their corporate parent.<sup>7</sup> When two or more domestic corporations file a consolidated return, losses that one corporation incurs generally are available to reduce or eliminate the income of other corporations in the consolidated group.<sup>8</sup>

Likewise, many other countries have a form of tax consolidation or “group relief” allowing the consolidation of the losses of affiliates with the income of other, profitable members of the group. For example, the U.K. has “group relief” allowing a loss affiliate to transfer its losses to profitable affiliates within the same group. Similarly, Germany has

*Organschaft* provisions whereby a profitable German company may acquire all of the losses of another German affiliate.

A corporation may be a domestic corporation for U.S. federal tax purposes and, at the same time, a tax resident of another country if, for tax purposes of that other country, a standard other than place of incorporation is used to determine tax residency (e.g., place of management and control). Such a corporation is referred to as a “dual resident corporation” (DRC).<sup>9</sup> A DRC is taxable in both the U.S. and in a foreign country. If, as described above, the foreign country has provisions similar to the U.S. consolidated return provisions that permit commonly controlled resident corporations to combine their income and losses, a DRC might be able (absent Section 1503(d)) to use its losses twice by offsetting the income of its



## Operation of Section 1503(d)

As noted above, Section 1503(d)(1) provides that, in general, a DCL of a domestic corporation cannot offset the taxable income of any other member of the corporation's consolidated group. For this purpose, "dual consolidated loss" means the net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a residence basis.<sup>11</sup> Under Section 1503(d)(2)(B), regulations were authorized allowing the use of a DCL to offset the income of a domestic affiliate if the loss does not offset the income of a foreign corporation under foreign law. On September 8, 1989, Temporary and Proposed Regulations under Section 1503(d) were published.<sup>12</sup> After comments were considered, the Proposed Regulations were amended and adopted as Final Regulations on September 9, 1992.<sup>13</sup>

Reg. 1.1503-2(g)(2) permits a taxpayer to elect to use a DCL to offset the income of a domestic affiliate by entering into an agreement with the IRS under which the taxpayer certifies that the DCL has not been, and will not be, used to offset the income of another person under the laws of a foreign country (a -2(g)(2) Election).<sup>14</sup> In addition, the taxpayer must file with its income tax return, for each of the 15 tax years following the tax year in which the DCL is incurred, a certification that the losses, expenses, or deductions that make up the DCL have not been used to offset the income of another person under the tax laws of a foreign country.<sup>15</sup>

Reg. 1.1503-2(g)(2)(iii)(A) provides that, in the year of a "triggering event," the taxpayer must recapture and report as gross income the amount of the DCL subject to a -2(g)(2) Election and pay an interest charge.<sup>16</sup> For this purpose, the following are treated as triggering events:

- In any tax year up to and including the 15th tax year following the year in which the DCL was incurred, any portion of the loss is used to offset the income of another person under the income tax laws of a foreign country.<sup>17</sup>
- An affiliated DRC or affiliated domestic owner ceases to be a member of

the consolidated group that filed the election.<sup>18</sup>

- An unaffiliated DRC or an unaffiliated domestic owner becomes a member of a consolidated group.<sup>19</sup>
- A DRC transfers assets in a transaction that results, under the laws of a foreign country, in a carryover of its losses.<sup>20</sup>
- A domestic owner of a separate unit<sup>21</sup> transfers assets of the separate unit in a transaction that results, under the laws of a foreign country, in a carryover of the separate unit's losses.<sup>22</sup>
- An unaffiliated DRC or unaffiliated domestic owner becomes a foreign corporation by means of a transaction (e.g., a reorganization) that, for foreign tax purposes, is not treated as involving a transfer of assets (and carryover of losses) to a new entity.<sup>23</sup>
- A domestic owner of a separate unit, either in a single transaction or series of transactions within a 12-month period, sells or otherwise disposes of 50% or more of the interest in the separate unit (measured by vote or value) owned by the domestic owner on the last day of the tax year in which the DCL was incurred.<sup>24</sup>
- The taxpayer fails to file the required annual certification.<sup>25</sup>

A taxpayer can rebut the presumption of a triggering event by demonstrating that the losses of the DRC or separate unit cannot be carried over or otherwise used under the laws of the foreign country and attaching documents demonstrating these facts to its tax return for the year in which the presumed triggering event occurs.<sup>26</sup>

The 1992 Final Regulations provided that if, *inter alia*, a closing agreement were entered into with the IRS and if a new -2(g)(2) Election were filed, the following events would not constitute triggering events:

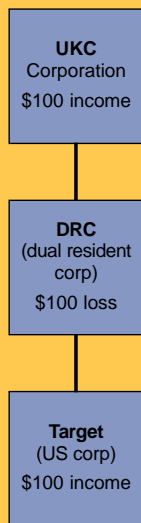
- An affiliated DRC or affiliated domestic owner became an unaffiliated domestic corporation or a member of a new consolidated group (see Exhibit 2).
- An unaffiliated DRC or unaffiliated domestic owner became a member of a consolidated group (see Exhibit 3).
- Assets of a DRC or a separate unit were acquired by an unaffiliated

domestic affiliates as well as its foreign country affiliates.

For example, before the enactment of Section 1503(d), the following scenario (adapted from an example originally found in the 1986 Blue Book) might have occurred (see Exhibit 1):

A U.K. corporation (UKC) earned \$100 of income per year and a U.S. target (Target) earned \$100 of income per year. To finance the purchase of Target, the U.K. corporation established a DRC that will incur annual interest expense of \$100. The DRC can share its annual loss of \$100 with UKC (so that the U.K. group's taxable income is reduced to \$0) and with Target (so that the U.S. consolidated group's taxable income is reduced to \$0). Despite an annual worldwide economic profit of \$100 (\$200 [profits] - \$100 [interest expense]), neither the U.K. group nor the U.S. group has an income tax liability.<sup>10</sup>

**EXHIBIT 1**  
Pre-Section 1503(d) Example



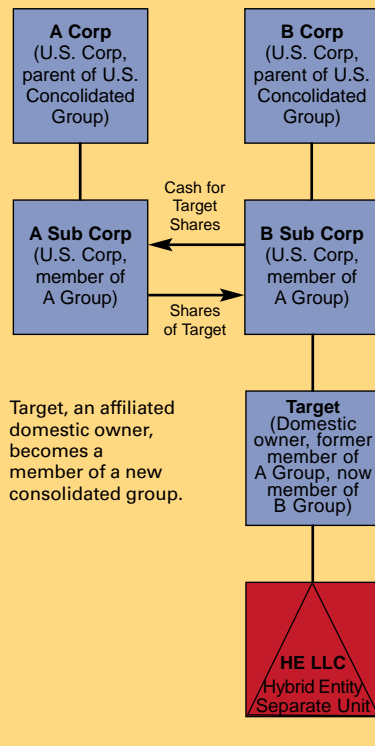
A U.K. corporation (UKC) earned approximately \$100 of income per year and a U.S. target (Target) earned approximately \$100 of income per year.

To finance the purchase of Target, UKC established a DRC that will incur annual interest expense of \$100.

DRC can effectively share its loss with UKC (so that the U.K. group's taxable income is reduced to \$0) and with Target (so that the U.S. consolidated group's taxable income is reduced to \$0).

Despite an annual worldwide profit of \$100 (\$200 [profit] - \$100 [interest expense]), neither the U.K. group nor the U.S. group has an income tax liability.

**EXHIBIT 2**  
Non-Triggering Event Under 1992 Final Regs.

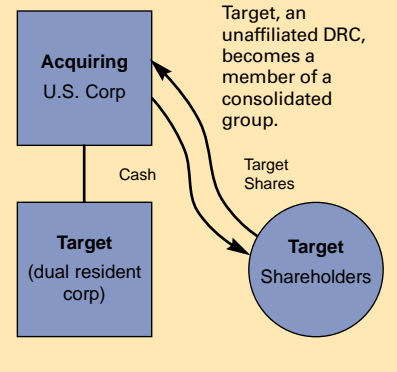


Target, an affiliated domestic owner, becomes a member of a new consolidated group.

**2002 Proposed Regulations**

As noted above, on July 31, 2002, the IRS issued new Proposed Regulations under Section 1503(d).<sup>28</sup> The IRS and Treasury believed that the closing agreement requirement (described above) imposed an unnecessary administrative burden in situations where several liability for the recapture of the DCL and interest charge would be imposed by Reg. 1.1502-6.<sup>29</sup> As such, the Proposed Regulations would have amended the 1992 Final Regulations by providing that a triggering event generally would not occur when:

**EXHIBIT 3**  
Non-Triggering Event Under 1992 Final Regs.



- An unaffiliated DRC or unaffiliated domestic owner of a “separate unit” became a member of a consolidated group.<sup>30</sup>
- A DRC or domestic owner of a separate unit that is a member of a consolidated group that filed a -2(g)(2) Election became a member of another consolidated group in an acquisition, as long as each member of the acquired group that is an includable corporation under Section 1504(b) was included immediately after the acquisition in a consolidated U.S. income tax return filed by the acquiring member.<sup>31</sup>

Under the Proposed Regulations, a statement was to be attached to the first consolidated return of the new consolidated group that included the DRC or domestic owner. This statement was to reference “Proposed Treasury Regulation Section 1.1503-2(g)(2)(iv)(A)(5),” and provide the name, address, identifying number, place, and date of incorporation of the DRC, and the countries that

domestic corporation or a member of a new consolidated group (see Exhibit 4).

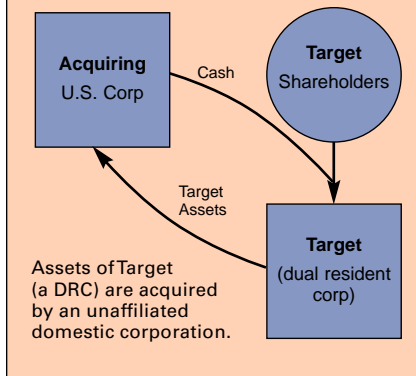
- A domestic owner of a separate unit transferred its interest in the separate unit to an unaffiliated domestic corporation or to a member of a new consolidated group (see Exhibit 5).<sup>27</sup>

1 H.R. 3838, 99th Cong., 1st Sess. (1985); TRA '86, PL. 99-514, 99th Cong., 2d Sess. (October 22, 1986).  
 2 This interest charge is computed under Section 6601(a) from the period in which the loss was used to reduce U.S. taxable income. Reg. 1.1503-2(g)(2)(vii)(A)(2).  
 3 See former Reg. 1.1503-2(g)(2)(iv)(B).  
 4 REG-106879-00, 67 Fed. Reg. 49892 (2002). See Caliano and Gregoire, “Dual Consolidated Losses: Proposed Regs. Relax Triggering-Event Rules,” 14 JOIT 22 (January 2003).  
 5 TD 9084, July 30, 2003. The Proposed Regulations were to be effective on or after the date that Final Regulations were published in the Federal Register (Prop. Reg. 1.1503-2(h)(1)), but the Final Regulations are effective as of January 1, 2002.

6 Sections 7701(a)(3)-(4). Under Reg. 1.1503-2(c)(1), “domestic corporation” also includes any corporation otherwise treated as a domestic corporation by the Code, including, but not limited to, Sections 269B (stapled entities), 953(d) (foreign insurance companies), and 1504(d) (contiguous foreign country corporations).  
 7 Section 1501.  
 8 Sections 1501 and 1502, and the Regulations thereunder.  
 9 Reg. 1.1503-2(c)(2).  
 10 Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (Blue Book), page 1064.  
 11 Section 1503(d)(2)(A).  
 12 54 Fed. Reg. 37314 (1989).

13 TD 8434, September 9, 1992 (1992-1 CB 240).  
 14 The agreement must be signed under penalties of perjury and must include the items in paragraphs labeled to correspond to Regs. 1.1503-2(g)(2)(i)(A)-(F).  
 15 Reg. 1.1503-2(g)(2)(vi)(B). The annual certification must be signed under penalties of perjury and must identify the DCL to which it pertains by setting forth the taxpayer's year in which the loss was incurred and the amount of the loss. In addition, the certification must warrant that arrangements have been made to ensure that the loss will not be used to offset the income of another person under the laws of a foreign country and that the taxpayer will be informed of any such foreign use of any portion of the loss. If DCLs of more than one tax year are subject to annual certification, the certifications

**EXHIBIT 4**  
Non-Triggering Event Under 1992 Final Regs.

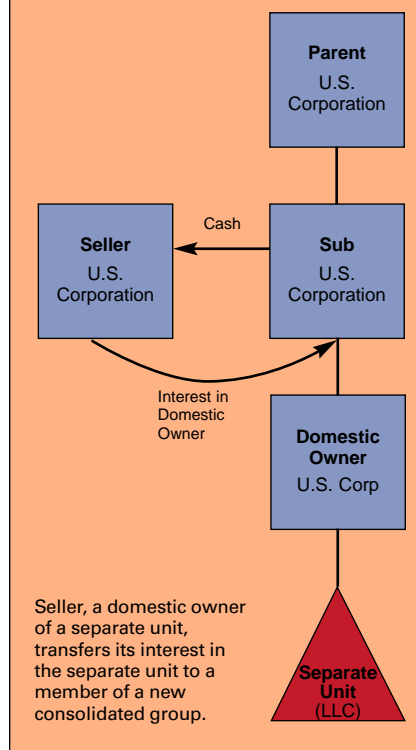


taxed the DRC on its worldwide income or on a residence basis, or, in the case of a separate unit, identification of the unit, including its name, principal activity, and the country in which its principal place of business was located. The statement also had to include the amount of the DCL and the year that such loss was incurred. The acquiring group had to continue to comply with the reporting requirements for the 15 years following the year that the DCL was incurred.<sup>32</sup>

**2003 Final Regulations**

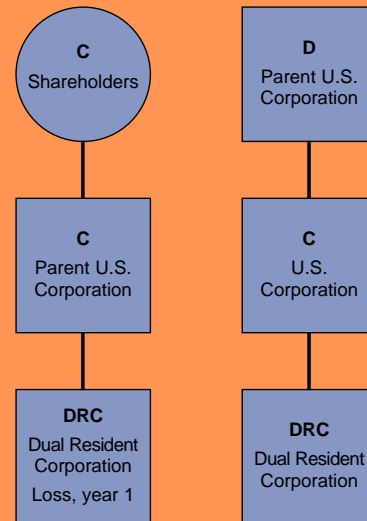
As noted above, the Proposed Regulations were designed to relieve taxpayers of the burden of entering into a closing agreement where several liability was imposed by Reg. 1.1502-6, and this liability, along with the original -2(g)(2) Election, would provide for liability of the acquiring group comparable to that under a closing agreement. The IRS noted in the Preamble to the Final Regulations that commenters had raised

**EXHIBIT 5**  
Non-Triggering Event Under 1992 Final Regs.



questions regarding comparable liability under Reg. 1.1502-6, in particular with respect to the interest charge, and recommended that the Final Regulations retain the requirement that the acquiring corporation or consolidated group enter into a new -2(g)(2) Election with respect to the DCL. While the IRS observed that Reg. 1.1502-6 provides an independent basis for several liability, the recommendation to retain the requirement for a new -2(g)(2) Election was adopted in the Final Regulations. The IRS determined that the

**EXHIBIT 6**  
Application of the Final Regulations



C is the common parent of a consolidated group (C Group) that includes DRC, a domestic corporation.

DRC incurs a DCL in its tax year ending December 31, Year 1.

The C Group elects to be bound by the provisions of Reg. 1.1502-2(g)(2) with respect to the Year 1 DCL.

No member of the C Group incurs a DCL in Year 2.

On December 31, Year 2, D acquires stock of C.

As a result of the acquisition, all C Group members, including DRC, become members of a consolidated group of which D is the common parent (D Group).

intended reduction in administrative burden could be accomplished through elimination of the closing agreement requirement in the situations specified in the Proposed Regulations. Moreover, with the retention of the requirement to file a new -2(g)(2) Election, the requirement in the Proposed Regulations to

for those years may be combined in a single document but each DCL must be identified separately.

<sup>16</sup> Reg. 1.1503-2(g)(2)(vii)(A).

<sup>17</sup> Reg. 1.1503-2(g)(2)(iii)(A)(1).

<sup>18</sup> Reg. 1.1503-2(g)(2)(iii)(A)(2). For this purpose, a DRC will be considered to cease to be a member of the consolidated group if it is no longer a member of the group or if the group ceases to exist because the common parent is no longer in existence, is no longer a common parent, or the group no longer files a consolidated return.

<sup>19</sup> Reg. 1.1503-2(g)(2)(iii)(A)(3).

<sup>20</sup> Reg. 1.1503-2(g)(2)(iii)(A)(4). For this purpose, a transfer, either in a single transaction or a series of transactions within a 12-month period, of 50% or more of the DRC's assets (measured

by the fair market value of the assets at the time of the transfer (or, for multiple transactions, at the time of the first transfer)) will be deemed a triggering event.

<sup>21</sup> The term "separate unit" means (1) a foreign branch (as defined in Temp. Reg. 1.367(a)-6T(g) (or a successor Regulation)), that is owned either directly by a domestic partnership or indirectly by a domestic corporation through ownership of a partnership or trust interest (regardless of whether the partnership or trust is a United States person), (2) an interest in a partnership, or (3) an interest in a trust. "Separate unit" also includes an interest in an entity that is not taxable as an association for U.S. income tax purposes but is subject to income tax in a foreign country as a corporation (or otherwise at the entity level either on its worldwide income or on a residence basis). Such

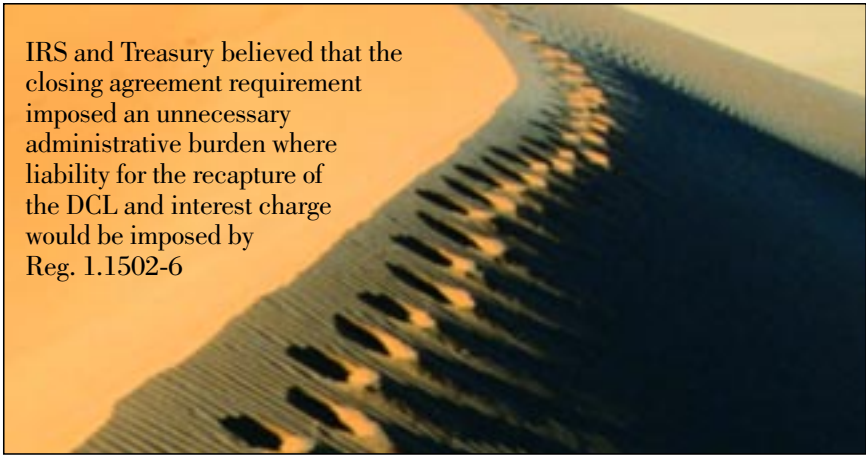
entities are "hybrid entity separate units." See Regs. 1.1503-2(c)(3)(i) and 1.1503-2(c)(4).

<sup>22</sup> Reg. 1.1503-2(g)(2)(iii)(A)(5). Again, for this purpose, a transfer, either in a single transaction or a series of transactions over a 12-month period, of 50% or more of the separate unit's assets (measured by the fair market value of the assets at the time of the transfer (or, for multiple transfers, at the time of the first transfer)), will be deemed a triggering event.

<sup>23</sup> Reg. 1.1503-2(g)(2)(iii)(A)(6).

<sup>24</sup> Reg. 1.1503-2(g)(2)(iii)(A)(7). For this purpose, the domestic owner will be deemed to have disposed of its entire interest in a hybrid entity separate unit if the hybrid entity separate unit becomes classified as a foreign corporation for U.S. tax purposes.

<sup>25</sup> Reg. 1.1503-2(g)(2)(iii)(A)(8).



IRS and Treasury believed that the closing agreement requirement imposed an unnecessary administrative burden where liability for the recapture of the DCL and interest charge would be imposed by Reg. 1.1502-6

file a separate information statement has been eliminated.

The IRS stated in the Preamble that commenters also suggested that any affiliated DRC or affiliated domestic owner should be permitted to join the acquiring group without causing a triggering event, regardless of whether all members of the consolidated group that filed the original -2(g)(2) Election also join the acquiring group, provided that the acquiring group files a new -2(g)(2) Election. This suggestion was not adopted in the Final Regulations. The Final Regulations contain a modified description of the types of transactions for which a closing agreement is no longer required, to make clear that all members of an acquired group (or their successors-in-interest) must be members of the acquiring group immediately after the acquisition (i.e., that no member of the acquired group, or its successor-in-interest, is excluded from the acquiring group due to an applicable restriction).<sup>33</sup>

As such, under the Final Regulations, if the new consolidated return group files a new -2(g)(2) Election,

the following will not be considered a triggering event:

- An unaffiliated DRC or unaffiliated domestic owner becomes a member of a consolidated group.
- A DRC or domestic owner that is a member of a consolidated group that filed a -2(g)(2) Election becomes a member of another consolidated group in an acquisition, as long as each member of the acquired group that is an includable corporation under Section 1504(b) is included immediately after the acquisition in a consolidated U.S. federal income tax return filed by the acquiring member.<sup>34</sup>

The following example demonstrates the application of the Final Regulations:

**Example.** C is the common parent of a U.S. consolidated group (C Group) that includes DRC, a domestic corporation. DRC incurs a DCL in its tax year ending December 31, Year 1. The C Group elects to be bound by the provisions of Reg. 1.1502-2(g)(2) with respect to the Year 1 DCL. No member of the C Group incurs a DCL in Year 2. On December 31, Year 2, D acquires stock of C. As a result of the acquisi-

tion, all of the C Group members, including DRC, become members of a consolidated group of which D is the common parent (D Group).<sup>35</sup> See Exhibit 6.

Under Reg. 1.1503-2(g)(2)(iv)(B)(2)(ii), the acquisition by D of the C Group is not an event requiring the recapture of the Year 1 DCL of C, or the payment of an interest charge provided that the D Group files a new -2(g)(2) Election.<sup>36</sup>

In subsequent tax years, if a triggering event occurs, the D Group will be required to recapture the DCL that DRC incurred in Year 1, as well as the payment of an interest charge. Each member of the D Group, including DRC and the other former members of the C Group, is severally liable for the additional tax (and the interest charge) due on the recapture of the DCL of DRC.<sup>37</sup>

## Conclusion

The Final Regulations deal only with situations where a DRC with a DCL joins a new or different U.S. consolidated group. The prior Regulations required that the new group enter into a closing agreement and become liable for the potential recapture of the DCL to avoid a triggering event. The Final Regulations recognize that under Reg. 1.1502-6, there is several liability among the members of the new group for any recapture tax owed by the newly acquired loss corporation and, thus, a closing agreement is not required. That said, the Final Regulations require that all members of the acquired group be members of the acquiring group immediately after the acquisition, and that the acquiring group file a new -2(g)(2) Election to replace the previously filed election. ●

<sup>26</sup> Reg. 1.1503-2(g)(2)(iii)(B). See also Regs. 1.1503-2(g)(2)(iii)(A)(1)-(8).

<sup>27</sup> Regs. 1.1503-2(g)(2)(iv)(B)(1)(i)-(iv). The closing agreement had to provide that the consolidated group, unaffiliated DRC, or unaffiliated domestic owner that originally filed the -2(g)(2) Election and the unaffiliated domestic corporation or new consolidated group would be jointly and severally liable for the total amount of the recapture of the DCL and interest charge if there was a subsequent triggering event. In addition to the closing agreement and the new -2(g)(2) Election, the unaffiliated domestic corporation or new consolidated group had to agree to treat any potential recapture amount as an unrealized built-in gain for purposes of Section 384(a) (sub-

ject to any applicable exceptions thereunder).

<sup>28</sup> Note 4, *supra*.

<sup>29</sup> Reg. 1.1502-6 generally provides that the common parent corporation and each member of a consolidated group are severally liable for the tax computed on their consolidated U.S. income tax return. In some circumstances, the several liability imposed by Reg. 1.1502-6 provides for liability comparable to that provided by a closing agreement under Reg. 1.1503-2(g)(2)(iv)(B)(2) and Section 7121.

<sup>30</sup> Prop. Reg. 1.1503-2(g)(2)(iv)(A)(4).

<sup>31</sup> Prop. Reg. 1.1503-2(g)(2)(iv)(A)(5).

<sup>32</sup> *Id.*

<sup>33</sup> The IRS will continue to consider this point,

and other alternatives for reducing the administrative burdens under Section 1503(d) and the regulations thereunder.

<sup>34</sup> Reg. 1.1503-2(g)(2)(iv)(B)(2). Under Reg. 1.1503-2(g)(2)(iv)(B)(3)(iii), the new -2(g)(2) Election must be filed with a timely filed income tax return for the tax year in which the event occurs; the obligations of the original -2(g)(2) Election must be assumed; the new election must be signed under penalties of perjury by the person who signs the return; and it must include a reference to Reg. 1.1503-2(g)(2)(iv)(B)(3)(iii).

<sup>35</sup> Reg. 1.1503-2(g)(2)(iv)(D)(i).

<sup>36</sup> Reg. 1.1503-2(g)(2)(iv)(D)(ii).

<sup>37</sup> Reg. 1.1503-2(g)(2)(iv)(D)(iii).