



**Proposed U.S. Regulations  
Regarding Dual Consolidated  
Losses**

**by Lewis J. Greenwald**

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# Proposed U.S. Regulations Regarding Dual Consolidated Losses

by *Lewis J. Greenwald*

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On May 19, 2005, the U.S. Treasury Department and Internal Revenue Service issued proposed regulations regarding dual consolidated losses (DCLs) under section 1503(d) of the U.S. Internal Revenue Code. The proposed regulations update the existing regulations to account for changes in the laws and regulations of the United States and other countries and seek to:

- minimize the over- and underinclusive applications of the current regulations;
- modernize the DCL regime to account for check-the-box regulations; and
- reduce the administrative burden imposed on taxpayers and the IRS by the current regulations.

The package of proposed regulations is massive, with a 71-page preamble, 84 pages of regulations, and 52 examples. This article provides a brief background to IRC section 1503(d) and then compares and contrasts the provisions of the current regulations with the provisions of the proposed regulations that will be relevant to most taxpayers. (For related coverage, see *Tax Notes Int'l*, May 30, 2005, p. 773; and *Tax Notes Int'l*, June 27, 2005, p. 1138.)

## IRC Section 1503(d)

In general, IRC section 1503(d)(1) provides that a DCL of a corporation cannot reduce the taxable income of any other member of the corporation's affiliated group. The statute defines a DCL as any net operating loss of a domestic corporation that is subject to taxation in a foreign country on its income, without regard to the source of its income, or is subject to tax on a residence basis. It also authorizes the issuance of regulations permitting 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.<sup>1</sup>

Section 1503(d)(3) further provides that, to the extent provided in regulations, similar rules apply to any loss of a "separate unit" of a domestic corporation as if the separate unit were a wholly owned subsidiary of the corporation.<sup>2</sup>

In 1989 Treasury and the IRS issued temporary regulations under IRC section 1503(d). The temporary regulations generally provided that, unless one of three limited exceptions applied, a DCL of a dual resident corporation (DRC) could not offset the income of any other member of the DRC's affiliated group.<sup>3</sup> The temporary regulations contained similar rules for losses incurred by separate units.

Responding to comments that the temporary regulations were unnecessarily restrictive, Treasury and the IRS in 1992 issued final regulations under IRC section 1503(d). Those final regulations were updated and amended over the next 11 years, resulting in the current regulations.

The current regulations establish the general rule that, except as otherwise provided, a DCL cannot offset the taxable income of any domestic affiliate, regardless of whether the loss offsets income of another entity under the income tax laws of a foreign country, and regardless of whether the income that the loss may offset in the foreign country is, has been, or will be subject to tax in the United States.<sup>4</sup> That general prohibition is subject to a number of exceptions, including elective relief (a -2(g)(2) election), wherein the taxpayer, among other things, is required to certify (and continue to certify for a 15-year period) that no portion of the DCL has been or will be used to offset the income of any other

<sup>1</sup>IRC section 1503(d)(2)(A) and (B), respectively.

<sup>2</sup>Although the statute does not define the term "separate unit," its legislative history refers to the loss of any separate and clearly identifiable unit of a trade or business of a taxpayer, and cites as an example a foreign branch of a domestic corporation.

<sup>3</sup>A DRC is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income, or on a residence basis.

<sup>4</sup>Treas. reg. section 1.1503-2(b)(1).

entity under the income tax laws of a foreign country. If those certifications are made and such a use (known as a triggering event) occurs, the DCL must be recaptured in the year of that triggering event (with an applicable interest charge).

## Structure of the Proposed Regulations

The proposed regulations are set forth in six sections:

- prop. Treas. reg. section 1.1503(d)-1 contains definitions and special rules;
- prop. Treas. reg. section 1.1503(d)-2 provides the operating rules, including the general rule that prohibits the domestic use of a DCL;
- prop. Treas. reg. section 1.1503(d)-3 contains special rules for accounting for DCLs;
- prop. Treas. reg. section 1.1503(d)-4 provides exceptions to the general rule, including the new “domestic use election”;
- prop. Treas. reg. section 1.1503(d)-5 contains the examples; and
- prop. Treas. reg. section 1.1503(d)-6 contains the proposed effective date.<sup>5</sup>

### Definitions and Special Rules

#### *DRCs/Separate Units*

The current regulations define a “separate unit” of a domestic corporation as a foreign branch, an interest in a partnership or trust, or an interest in a hybrid entity. The regulations state that unless otherwise indicated, any reference to a DRC is also a reference to a separate unit. Certain provisions of the regulations refer only to DRCs; other provisions refer both to DRCs and separate units.

The proposed regulations define a separate unit as a foreign branch or an interest in a hybrid entity that is owned, directly or indirectly, by a domestic corporation. The proposed regulations eliminate an interest in a partnership or trust from the definition of a separate unit. Additionally, the proposed regulations treat separate units as domestic corporations for only limited purposes, and modify the operative rules as needed to take into account differences between DRCs and separate units.

#### *The Combination Rule*

The current regulations provide that if two or more foreign branches located in the same foreign country are owned by a single domestic corporation, and the losses of each branch are made available to

offset the income of the other branches under the tax laws of the foreign country, then the branches are treated as one separate unit.<sup>6</sup> (This is known as the “combination rule.”)

The combination rule in the current regulations does not apply to interests in DRCs, nor does it apply to hybrid entity separate units.

The IRS and Treasury now believe that the combination rule should not be restricted to foreign branches. In addition, they believe that the rule should not be limited to cases in which the domestic corporation owns the separate units directly. As such, the proposed regulations adopt a much broader combination rule that allows the combination of all separate units that are directly or indirectly owned by a single domestic corporation.

#### *Exception to the Definition of a DCL*

The current regulations provide a very limited exception to the definition of a DCL in cases in which the income tax laws of a foreign country do not permit the DRC to use its losses, expenses, or deductions to offset the income of any other entity, either in the current tax year or in other tax years.<sup>7</sup> Because the IRS and Treasury believe that some taxpayers have improperly interpreted this exception, it has been eliminated in the proposed regulations and replaced with a “no possibility of foreign use” rule (see below).

#### *Domestic Use of a DCL*

As noted above, the current regulations provide the general rule that, except as otherwise provided, a DCL cannot offset the taxable income of any domestic affiliate, regardless of whether the loss offsets income of another entity under the income tax laws of a foreign country, and regardless of whether the income that the loss may offset in the foreign country is, has been, or will be subject to tax in the United States.

The proposed regulations retain the general rule that prohibits the use of a DCL against the taxable income of any domestic affiliate, but now refer to that usage as the “domestic use” of a DCL. As with the current regulations, that general prohibition is subject to a number of exceptions (found in prop. Treas. reg. section 1.1503(d)-4, as discussed below).

#### *Foreign Use of a DCL*

As noted above, the current regulations provide that in order to make a -(2)(g)(2) election, the taxpayer must, among other things, certify that no portion of the loss has been or will be used to offset the income of another entity under the income tax

<sup>5</sup>The proposed regulations also include conforming proposed amendments to Treas. reg. sections 1.1502-21 and 1.6043-4T.

<sup>6</sup>Treas. reg. section 1.1503-2(c)(3)(ii).

<sup>7</sup>Treas. reg. section 1.1503-2(c)(5)(ii)(A).

laws of a foreign country. If there is ever such a use, the DCL must be recaptured and reported as gross income (with interest).

The proposed regulations modify the definition of use and establish a rule based on foreign use. The modifications are intended to minimize potential over- and underinclusive applications of the DCL rules under the current regulations.

The proposed regulations provide that a foreign use is deemed to occur only if two conditions are satisfied. The first condition is satisfied if any portion of a loss or deduction taken into account in computing the DCL is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws (including items of income or gain generated by the DRC or separate unit itself), regardless of whether the income or gain is actually offset, and regardless of whether those items are recognized under U.S. tax principles. The second condition is satisfied if items that could be offset in accordance with the first condition are considered, under U.S. tax principles, to be items of a foreign corporation or a direct or indirect (for example, through a partnership) owner of an interest in a hybrid entity, provided that such interest is not a separate unit.

#### *Mirror Legislation Rule*

The current regulations contain a “mirror legislation rule” that addresses legislation enacted by foreign jurisdictions that operates in a manner similar to the DCL rules.<sup>8</sup> The mirror legislation rule provides that if the laws of a foreign country deny the use of a loss of a DRC (or a separate unit) to offset the income of another entity because the DRC (or separate unit) is also subject to tax by another country on its worldwide income or on a residence basis, the loss is deemed to be used against the income of another entity in that foreign country so that no -(2)(g)(2) election can be made with respect to the loss. This rule is intended to prevent foreign jurisdictions from enacting legislation that gives taxpayers no choice but to use a DCL to offset income in the United States.

The proposed regulations retain the mirror legislation rule and clarify that it applies even in the absence of an affiliate in the foreign country, or the failure to make an election to enable a foreign use. That said, Treasury and the IRS understand that there may be uncertainty about the application of the mirror legislation rule in a case in which the mirror legislation at issue is limited in its application. As such, the proposed regulations also clarify

that the mere existence of mirror legislation, regardless of whether it applies to a particular DRC, may not result in a deemed foreign loss.

#### *Reasonable Cause Exception*

The regulations require various filings to be included with a timely filed tax return; taxpayers that fail to include those filings with a timely filed tax return must request an extension of time to file under Treas. reg. section 301.9100-3.

The IRS and Treasury now believe that requiring taxpayers to request an extension under Treas. reg. section 301.9100-3 results in an unnecessary administrative burden on both taxpayers and the IRS, and that a “reasonable cause exception” is a more appropriate and less burdensome way for taxpayers to resolve compliance defects under IRC section 1503(d). Under the proposed regulations, extensions under Treas. reg. section 301.9100-3 would no longer be available.

**The proposed regulations define a separate unit as a foreign branch or an interest in a hybrid entity that is owned, directly or indirectly, by a domestic corporation.**

Under the reasonable cause exception, if an entity that is permitted or required to file an election, agreement, statement, rebuttal, computation, or other information fails to do so in a timely manner, that entity shall be considered to have satisfied the timeliness requirement if it is able to demonstrate, to the satisfaction of the director of field operations who has jurisdiction over the taxpayer’s tax return for the tax year, that there was reasonable cause for the failure, and that it was not due to willful neglect. Once the taxpayer becomes aware of the failure, it must demonstrate reasonable cause and comply by attaching all the necessary filings to an amended tax return, including a written statement explaining the reasons for its failure to comply.

#### **Operating Rules**

##### *Application of Rules to Multiple Tiers of Separate Units*

Treas. reg. section 1.1503-2(b)(3) provides that if a separate unit of a domestic corporation is owned indirectly through another separate unit, limitations on the DCLs of the separate units apply as if the upper-tier separate unit were a subsidiary of the domestic corporation, and the lower-tier separate unit were a lower-tier subsidiary (the “stacking” rule). In light of changes made to other provisions of the proposed regulations, the stacking rule is no

<sup>8</sup>Treas. reg. section 1.1503-2(c)(15)(v).

longer necessary. As a result, the proposed regulations do not contain that provision.

### Accounting for DCLs

#### *Items and Income Attributable to a Separate Unit — General Rules*

The current regulations provide a rule for determining whether a separate unit has a DCL. Under that rule, the separate unit must compute its taxable income as if it were a separate domestic corporation, using only those items of income, expense, deduction, and loss that are otherwise attributable to the separate unit. The current regulations do not provide guidance for determining the items of income, gain, deduction, and loss that are otherwise attributable to a separate unit. Open issues include:

- whether any or all of the interest expense of a domestic owner is attributable to a separate unit;
- whether a transaction between a separate unit and its owner that generally is disregarded for U.S. federal tax purposes can create an item of income, gain, deduction, or loss for purposes of calculating a DCL (for example, interest paid by a disregarded entity to its owner); and
- whether each separate unit in a tiered separate unit structure must separately determine whether it has a DCL, or whether the separate units are combined for that purpose.

The proposed regulations clarify that only *existing* tax accounting items of income, gain, deduction, and loss are to be taken into account for purposes of calculating the DCL of a separate unit. In other words, items that are disregarded for U.S. federal tax purposes (such as interest paid by a disregarded entity to its owner) also are disregarded for purposes of calculating a separate unit's DCL.

The proposed regulations also clarify that in the case of tiered separate units, each separate unit must calculate its own DCL, and no item of income, gain, deduction, or loss is to be taken into account in determining the taxable income or loss of more than one separate unit. Similarly, the proposed regulations clarify that items of one separate unit cannot offset or otherwise be taken into account by another separate unit for purposes of calculating a DCL (unless the combination rule applies).

The proposed regulations provide additional guidance for calculating income attributable to foreign branch separate units, hybrid entity separate units, disregarded hybrid entity separate units, hybrid entity partnerships, and hybrid entity grantor trusts.

#### *Gain or Loss Recognized on Dispositions of Separate Units*

The current regulations do not indicate whether items of income, gain, deduction, and loss recognized

on the sale or disposition of a separate unit are attributable to or taken into account by the separate unit for purposes of calculating its DCL for the year of the sale, or for purposes of reducing the amount of recapture as a result of a triggering event.

The IRS and Treasury now believe that it is appropriate to take into account items of income, gain, deduction, and loss recognized on those dispositions. Thus, the proposed regulations provide that items of income, gain, deduction, and loss recognized on the disposition of a separate unit are attributable to or taken into account by the separate unit to the extent of the gain or loss that would have been recognized if the separate unit had sold all of its assets in a taxable exchange, immediately before the disposition of the separate unit, for an amount equal to their fair market value.

#### *Income Inclusions*

The current regulations do not indicate whether income arising from the ownership of stock in a foreign corporation (an income inclusion) is attributable to or taken into account by a separate unit that owns the stock that gave rise to the income inclusion. For example, if a domestic corporation has an IRC section 951(a) inclusion attributable to the stock of a controlled foreign corporation that is owned by a hybrid entity separate unit, it is not clear under the regulations whether that income inclusion is taken into account for purposes of calculating the DCL of the hybrid entity separate unit.

The IRS and Treasury now believe that, solely for purposes of applying the DCL rules, it is appropriate to treat income inclusions arising from the ownership of stock in the same manner that dividend income is treated. Accordingly, the proposed regulations provide that income inclusions are taken into account for purposes of calculating a DCL of a separate unit if an actual dividend from the foreign corporation would have been taken into account.

#### *IRC Section 987 Gains and Losses*

The current regulations do not address whether the IRC section 987 gains or losses of a domestic owner are attributable to or are taken into account by a separate unit for purposes of calculating the separate unit's DCL. Because the IRS and Treasury have an open regulations project under IRC section 987 and expect to issue new regulations under section 987, they did not address that issue in the proposed regulations.

### Exceptions to General Rule Against Domestic Use

#### *No Possibility of Foreign Use*

As noted above, the current regulations provide a very limited exception to the definition of a DCL in cases in which the income tax laws of a foreign country do not permit the DRC to use its losses,

expenses, or deductions to offset the income of any other entity, either in the current tax year or in other tax years. That exception has been eliminated in the proposed regulations and replaced with a “no possibility of foreign use” rule. To qualify under this new exception, a taxpayer must demonstrate to the satisfaction of the IRS that there can be no foreign use of the DCL at any time and prepare and attach a statement to its tax return for the tax year in which the DCL is incurred. The statement must include an analysis (with reasonable detail and specificity), supported with an official or certified English translation of the relevant provisions of foreign law, of the treatment of the losses and deductions composing the DCL, and the reasons supporting the conclusion that there cannot be foreign use of the DCL by any means at any time.

Consistent with the definitional exception in the current regulations, the IRS and Treasury believe that the new exception will apply only in rare and unusual circumstances. If a foreign jurisdiction recognizes any item of deduction or loss composing the DCL — regardless of whether it is recognized currently or deferred (by being reflected in the basis of assets) — and that item is available for foreign use through a form of consolidation, carryover or carry-back, or a transaction (for example, a merger, basis carryover transaction, or entity classification election), then the exception will not apply.

#### *Domestic Use Election Agreement*

As discussed above, the current regulations provide an exception to the general rule prohibiting the use of a DCL if a -2(g)(2) election is made. The proposed regulations retain that elective exception, but refer to it as a “domestic use election.”

#### *Seven-Year Certification Period*

As noted above, if a taxpayer makes a -2(g)(2) election under the regulations, it must certify in each of the 15 years following the year of the election (the certification period) that a triggering event has not occurred.<sup>9</sup>

The IRS and Treasury now believe that a 15-year certification period is not required to deter and monitor double dipping of losses and deductions, and is unnecessarily burdensome to both taxpayers and the IRS. The proposed regulations reduce the certification period from 15 years to 7 years.

#### *Restrictions on Domestic Use Elections in Year of A Triggering Event*

The current regulations do not explicitly address situations in which a triggering event occurs in the year in which the DCL is incurred. The proposed regulations make it clear that a domestic use elec-

tion cannot be made for a DCL incurred in the same year in which a triggering event occurs with respect to such loss.

#### *Triggering Events — In General*

As noted above, the current regulations provide rules related to certain triggering events that require the recapture of previously allowed DCLs (subject to the taxpayer’s ability to rebut the triggering event). Under those rules, if a -2(g)(2) election has been made, the taxpayer must report as income the amount of the DCL (and pay an interest charge) if a triggering event occurs during the certification period. In general, the proposed regulations retain the triggering event rules contained in the current regulations (including the ability to rebut).

#### *Amount of Recapture*

Under the current regulations, a triggering event (other than a foreign use) generally can be rebutted if no portion of the DCL can be used by, or carried over to, another entity under foreign law. That said, if even a de minimis portion of the DCL can be used by, or carried over to, another entity, the triggering event cannot be rebutted. Similarly, the current regulations provide that if a triggering event occurs, the entire DCL that is subject to the -2(g)(2) election is recaptured and reported as income, regardless of the amount of the DCL used by the other entity. Thus, even a de minimis foreign use will cause the entire amount of the DCL to be recaptured and reported as income. This so-called “all or nothing” principle is included in the current regulations primarily because of administrative concerns, and is retained in the proposed regulations.

#### *Failure-to-Comply Penalty*

Under the regulations, if a taxpayer fails to comply with the recapture provision, the DRC or separate unit (or successor-in-interest) generally is not eligible to enter into a -2(g)(2) election for any DCL incurred in the five tax years beginning with the tax year in which recapture is required.

The IRS and Treasury believe that the failure-to-comply penalty in the current regulations often does not operate in a manner that encourages compliance with the DCL regulations. For example, if a taxpayer sells a DRC to a third party, the sale is treated as a triggering event. If the taxpayer fails to comply with the recapture rules, the failure-to-comply penalty in the regulations prevents the purchaser of the DRC from entering into a -2(g)(2) election regarding the DCLs of the DRC for five years, but it does not adversely affect the taxpayer that failed to properly comply with the recapture provisions.

The proposed regulations do not include a failure-to-comply penalty. Nevertheless, the IRS may consider applying other applicable penalty provisions in appropriate circumstances (for example, the accuracy-related penalty of IRC section 6662). In

<sup>9</sup>See Treas. reg. section 1.1503-2(g)(2)(iii)(A).

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addition, the IRS and Treasury will continue to consider whether a penalty provision similar to the one contained in the regulations is appropriate, especially in cases of repeated noncompliance.

### Examples

As noted above, prop. Treas. reg. section 1.1503(d)-5 contains 52 examples illustrating the provisions of the proposed regulations.

### Effective Date

The proposed regulations are intended to apply to DCLs incurred in tax years beginning after the date

that the proposed regulations are finalized. That said, the IRS and Treasury have requested comments about whether the proposed regulations, when finalized, should contain an election that would allow taxpayers to apply all or a portion of the proposed regulations retroactively. In addition, comments have been requested regarding possible transition rules that might apply, including the application of the proposed regulations, when finalized, to existing -2(g)(2) elections. ♦

Rule	Current Regulations	Proposed Regulations
“Separate unit” is defined as a foreign branch, an interest in a partnership or trust, or an interest in a hybrid entity	Yes	No, an interest in a partnership or trust is eliminated from the definition of a “separate unit”
Reference to a DRC is also a reference to a “separate unit”	Yes	No
Combination rule is limited to foreign branches owned directly by a single domestic corporation	Yes	No, combination rule expanded to include all separate units that are directly and indirectly owned by a single domestic corporation
Exception to the definition of a DCL when the income tax laws of a foreign country do not allow the use of a loss against the income of any other entity	Yes	No, definition exception eliminated in favor of a new “no possibility of foreign use” rule
Mirror legislation rule	Yes	Yes, but clarify that the “mere existence” of mirror legislation may not result in a deemed foreign loss
IRC section 9100 relief available for missed filings	Yes	No, replaced with a new reasonable cause exception that is claimed with an amended return
“Stacking” rule for separate units owned by other separate units	Yes	No
Only existing tax accounting items of income, gain, deduction, and loss taken into account in calculating a DCL	Unclear	Yes, items that are disregarded for U.S. federal tax purposes (for example, interest paid by a disregarded entity to its owner) are not taken into account in calculating a DCL
Gain or loss recognized on the disposition of separate units	Unclear	Yes, taken into account by the separate unit in calculating its DCL to the extent that gain or loss would have been recognized on the sale of all of its assets
IRC section 987 gains and losses taken into account in calculating a DCL	Not addressed	Not addressed
Elective relief from the general rule prohibiting the use of a DCL	Yes, often referred to as a “-2(g)(2) election”	Yes, but now referred to as a “domestic use election”
Fifteen-year certification period	Yes	No, the certification period would be reduced to seven years
Elective relief available in the year of a triggering event	Unclear	No
Triggering events require the recapture of previously allowed DCLs	Yes	Yes
Failure-to-comply penalty	Yes	No