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SPECIAL REPORTS

The Remarkable Taxpayer-Friendly Evolution of the DCL Regime

by Lewis J. Greenwald and Eric J. Fuselier

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The U.S. international tax provisions are fraught with technical complexity — the outbound transfer rules of Internal Revenue Code section 367(a), the overall foreign/separate limitation loss rules of IRC section 904(f), and the branch rules of IRC section 954(d)(2) immediately come to mind.

Equally challenging are the dual consolidated loss (DCL) rules of the IRC section 1503(d) regulations.[1] That said, there has been a remarkable, taxpayer-friendly evolution of the DCL regulations with the 2005 proposed regulations and the 2007 final regulations. This remarkable evolution has included the expansion, elimination, or substitution of several key provisions found in the 1992 final regulations that should greatly enhance taxpayers' ability to comply with the DCL regime and should eliminate many of the inadvertent mistakes caused by the 1992 final regulations.

More specifically, there has been:

- a significant expansion of the combination rule (to include all branches and disregarded entities that are owned by all members of the same consolidated group);
- the elimination of the consistency rule;
- the adoption of a reasonable cause exception for missed elections and annual certifications (in lieu of a request for an extension of time to file under reg. sections 301.9100-1 through 301.9100-3);
- an expansion of the exceptions to the foreign use rule;
- an important new exception to the mirror rule;
- the elimination of the difficult DCL basis adjustment rules (in favor of the normal basis adjustment rules of reg. section 1.1502-32); and
- a dramatic shortening of the certification period.

Expansion of Combination Rule

The 1992 final regulations provided that if two or more foreign branches located in the same foreign country were owned by a single domestic corporation, and the losses of each branch were made available to offset the income of the other branches under the tax laws of the foreign country, then the branches were treated as one separate unit (the combination rule).[2]

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[1]In general, IRC section 1503(d) 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 either (1) is subject to an income tax of a foreign country on its income without regard to the source of its income or (2) is subject to an income tax on a residence basis. The statute 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.

In 1989 the IRS and Treasury issued temporary regulations under IRC section 1503(d). In response to comments that the temporary regulations were unnecessarily restrictive, in 1992 the IRS and Treasury issued final regulations. The 1992 final regulations were updated and amended over the next 11 years.

On May 24, 2005, the IRS and Treasury issued proposed regulations; on March 16, 2007, the 2005 proposed regulations were issued in final form with significant modifications.

[2]1992 reg. section 1.1503-2(c)(3)(ii).

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The combination rule of the 1992 final regulations did not apply to interests in hybrid entity separate units (that is, disregarded entities) or to dual resident corporations (DRCs).[3] It also required that the foreign branches be owned by a single domestic corporation.[4] As such, the combination rule did not permit the combination of foreign branches owned by different domestic corporations (even if those corporations were members of the same consolidated group).[5] Also, in some cases it did not allow the combination of foreign branches that were owned indirectly by a single domestic corporation through other separate units (because those other separate units were generally treated as domestic corporations for purposes of applying the DCL rules).[6]

In response to comments that the combination rule was unnecessarily limited and did not appropriately address the check-the-box regulations, the 2005 proposed regulations adopted a broader combination rule. Subject to some requirements, this broader combination rule combined all separate units owned directly and indirectly by a single domestic corporation.[7] However, as with the 1992 final regulations, for separate units to be combined, the losses of each separate unit had to be made available to offset the income of the other separate units under the tax law of a single foreign country.[8] Also, if the separate unit was a foreign branch separate unit, it had to be located in a foreign country that allowed its losses to be made available to offset income of each separate unit.[9] If the separate unit was a hybrid entity separate unit, the hybrid entity had to be subject to tax in the foreign country that allowed losses to be made available to each separate unit either on its worldwide income or on a residence basis.[10] That said, the new combination rule did not allow the combination of separate units owned by different domestic corporations (even if the domestic corporations were members of the same consolidated group).[11] Also, the new combination rule did not apply to DRCs.[12]

Many comments were received on the scope and application of the new combination rule.[13] Commentators uniformly recommended that the combination rule be expanded to include same-country separate units that are owned by multiple domestic corporations that are members of the same consolidated group.[14] The IRS and Treasury agreed with this comment as being consistent with the underlying policies of IRC section 1503(d).[15] The combination rule of the 2007 final regulations applies to all same-country separate units of multiple domestic corporations that are members of the same consolidated group.[16]

Another commentator recommended eliminating the 2005 proposed regulations' requirement that losses of each separate unit must be available to offset the income of other separate units under the tax laws of a single foreign country for them to combine.[17] The IRS and Treasury believed that it was appropriate to remove this requirement, provided that the individual separate units are located, or are subject to income tax on a worldwide or residence basis, in the same foreign country.[18] As a result, the 2007 final regulations eliminate this requirement from the combination rule.[19]

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[3]*Id.* Although a disregarded entity is treated as a branch of its owner for various purposes of the IRC, the 1992 final regulations distinguished a hybrid entity separate unit that is disregarded as an entity separate from its owner from a foreign branch separate unit. *Compare* 1992 reg. section 1.1503-2(c)(3)(i)(A) and (c)(4); *see also* 1992 reg. section 1.1503-2(g)(2)(vi)(C). As such, the combination rule of the 1992 final regulations did not apply to an interest in a hybrid entity separate unit, even if the hybrid entity was disregarded as an entity separate from its owner.

[4]*Id.*

[5]*Id.*

[6]1992 reg. section 1.1503-2(c)(2).

[7]2005 prop. reg. section 1.1503(d)-1(b)(4)(ii).

[8]*Id.*

[9]*See* the preamble to REG-102144-04 and 2005 prop. reg. section 1.1503(d)-1(b)(4)(ii)(A).

[10]*See* the preamble to REG-102144-04 and 2005 prop. reg. section 1.1503(d)-1(b)(4)(ii)(B).

[11]*See* the preamble to REG-102144-04.

[12]*Id*. The IRS and Treasury requested comments on: (1) the authority to expand the combination rule and whether the combination rule should be expanded to include separate units that were owned directly or indirectly by domestic corporations that were members of the same consolidated group; (2) whether the application of the combination rule should be extended to DRCs; and (3) the application of the operative DCL provisions to combined separate units owned by different domestic corporations (e.g., the SRLY limitation under 2005 prop. reg. section 1.1503(d)-3(c)). *See* the preamble to REG-102144-04.

[13]*See* the preamble to T.D. 9315, 72 F.R. 12902-12946.

[14]*Id.*

[15]*Id.*

[16]2007 reg. section 1.1503(d)-1(b)(4)(ii).

[17]*See* the preamble to T.D. 9315, *supra* note 13.

[18]*See supra* note 16.

[19]*Id.* Two commentators recommended that the combination rule be expanded to include DRCs that are members of the same consolidated group. The IRS and Treasury indicated that they believe that Congress did not intend that multiple DRCs be treated as a single corporation for purposes of IRC section 1503(d). Also, the IRS and Treasury stated that they believe that combining DRCs and separate units would add complexity to the DCL rules because some rules apply differently to DRCs and separate units. As a result, the combination rule of the 2007 final regulations was not expanded to include DRCs. However, in the preamble, the IRS and Treasury noted that a DRC will often carry on its activities through a foreign branch (as defined in reg. section 1.367(a)-6T(g)(1)) and, as a result, will be a domestic

(Footnote continued on next page.)

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The 2007 final regulations also clarify that the combination rule generally applies for all purposes of IRC section 1503(d).[20] Therefore, except as specifically provided, any individual separate unit composing a combined separate unit loses its character as an individual separate unit.[21] For example, in determining whether there is a triggering event (as a result of the transfer of the assets of a combined separate unit), all of the assets of the combined separate unit are taken into account (rather than only the assets of any individual separate unit within the combined separate unit).[22]

Elimination of Consistency Rule

Under the consistency rule of the 1992 final regulations, if any loss, expense, or deduction taken into account in computing the DCL of a DRC or separate unit was used under the laws of a foreign country to offset the income of another person, then the following other DCLs (if any) were treated as also having been used to offset income of another person under the laws of that foreign country (but only if the income tax rules of the foreign country permitted any loss, expense, or deduction taken into account in computing the other DCL to be used to offset the income of another person in the same tax year):

- any DCL of a DRC that was a member of the same consolidated group of which the first DRC or domestic owner was a member, if any loss, expense, or deduction taken into account in computing the DCL was recognized under the income tax laws of the country in the same tax year; and
- any DCL of a separate unit that was owned by the same domestic owner that owned the first separate unit, or that was owned by any member of the same consolidated group of which the first DRC or domestic owner was a member, if any loss, expense, or deduction taken into account in computing the DCL was recognized under the income tax laws of that country in the same tax year.[23]

The consistency rule was intended to ensure that a consolidated group or domestic owner treated uniformly all DCLs of its DRCs or separate units that it owned that were available for use in a foreign country in a given year.[24] The rule was also intended to minimize the administrative burden associated with identifying the items of loss or deduction of a particular DCL that were used to offset income of another person under the income tax laws of a foreign country.[25]

However, as a result of the expansion of the combination rule in the 2007 final regulations (as discussed above), the IRS and Treasury believed that the consistency rule would have only limited continuing application.[26] Therefore, the consistency rule was eliminated by the 2007 final regulations.[27]

Adoption of Reasonable Cause Exception

The 1992 final regulations required various filings to be included with a timely filed tax return.[28] Taxpayers that failed to include these filings on a timely filed tax return had to request an extension to file under reg. sections 301.9100-1 through 301.9100-3.[29] Because this caused a jam in administration, the IRS and Treasury believed that the adoption of a reasonable cause standard (similar to that used in other U.S. international provisions of the code, for example, IRC sections 367(a) and 6038B) was a more appropriate and less burdensome means for taxpayers to cure compliance defects under IRC section 1503(d).[30] As a result, the 2005 proposed regulations adopted a reasonable cause standard.[31]

Under the reasonable cause standard, if a person that was permitted or required to file an election, agreement, statement, rebuttal, computation, or other information under the regulations failed to make a filing in a timely manner, the person would be considered to have satisfied the timeliness requirement for the

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owner of a foreign branch separate unit. In these cases, the foreign branch separate unit through which it carries on its activities in the foreign country will be eligible for combination. Also, in many cases, a significant number of the items of income, gain, deduction, and loss of a DRC that owns a foreign branch separate unit will be attributable to the foreign branch separate unit (and therefore will not be items of the DRC itself). As a result, not extending the combination rule to DRCs should, as a practical matter, have limited effect.

Commentators also recommended making combination elective in some situations. The IRS and Treasury indicated that they believe that elective combination would add complexity and create administrative burdens. Therefore, making the combination rule elective in some situations was not adopted. *See* the preamble to T.D. 9315, *supra* note 13.

[20] *See* the preamble to T.D. 9315, *supra* note 13.

[21] *Id.* 2007 reg. section 1.1503(d)-1(b)(4)(ii).

[22] *See* the preamble to T.D. 9315, *supra* note 13.

[23] 1992 reg. section 1.1503-2(g)(2)(ii).

[24] *See supra* note 11.

[25] *Id.*

[26] *See* the preamble to T.D. 9315, *supra* note 13.

[27] *Id.*

[28] 1992 reg. section 1.1503-2(g)(2)(i) and (vi).

[29] *See supra* note 11.

[30] *Id.* It is probably not an exaggeration that hundreds, if not thousands, of requests for extensions to file under reg. sections 301.9100-1 through 301.9100-3 were filed for missed 1992 reg. section 1.1503-2(g)(2) elections and annual certifications.

[31] 2005 prop. reg. section 1.1503(d)-1(c)(1).

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filing if the person was able to demonstrate, to the satisfaction of the director of field operations having jurisdiction of the taxpayer's tax return for the tax year, that the failure was due to reasonable cause and not willful neglect.[32] Once the person became aware of the failure, the person had to make this demonstration and comply by attaching all the necessary filings to an amended return, and include a written statement that explained the reasons for the failure to comply.[33] As a result of the expansion of the combination rule in the 2007 final regulations the IRS and Treasury believed that the consistency rule would have only limited continuing application.

In determining whether the taxpayer had reasonable cause, the director of field operations had to consider whether the taxpayer acted reasonably and in good faith.[34] This was determined after considering all the facts and circumstances.[35] The director of field operations had to notify the person in writing within 120 days of the filing if it was determined that the failure to comply was due to reasonable cause, or if additional time was needed to make the determination.[36]

On January 31, 2006, the IRS and Treasury published Notice 2006-13,[37] in which it was announced that taxpayers might cure their late IRC section 1503(d) filings by applying a reasonable cause exception (similar to the standard in the 2005 proposed regulations), until the 2005 proposed regulations became final.[38] In addition to allowing the use of the reasonable cause exception before the 2005 proposed regulations became final, the notice modified the procedures for obtaining reasonable cause relief to ensure that requests for reasonable cause relief were handled in a timely and efficient manner.[39]

The 2007 final regulations adopted the reasonable cause standard in the 2005 proposed regulations, with the following modifications. Similar to the notice, the 2007 final regulations:

- clarify that to show reasonable cause, the taxpayer must demonstrate that it exercised ordinary care and prudence in meeting its tax obligations but did not comply with the prescribed duty within the prescribed time;
- provide that the 120-day period will begin on the date the taxpayer is notified in writing that the request has been received and assigned for review; however, the 2007 final regulations further provide that if the taxpayer is not again notified within the 120-day period once the initial period begins, the taxpayer will be deemed to have established reasonable cause; and
- in addition to filing an amended return, to which all documents that should have been filed are attached, the taxpayer must also provide a copy of the amended return and all required attachments to the director in a manner that is dependent on whether the taxpayer is under examination for the tax year(s) for which the taxpayer requests relief.[40]

Expansion of Exceptions to Foreign Use Rule

The 1992 final regulations provided that, to elect relief from the general limitation on the use of a DCL, the taxpayer must certify that no portion of the losses, expenses, or deductions had been, or would have been, used to offset the income of another person under the income tax laws of a foreign country.[41] If, contrary to this election/certification, there was a prohibited use of the DCL (a triggering event), the DCL had to be recaptured (reported as gross income) and U.S. federal income tax paid thereon, with interest.[42]

The IRS and Treasury understood that some issues arose involving the application of the ''use'' rule in the 1992 final regulations.[43] The IRS and Treasury also understood that taxpayers had taken positions under the 1992 final regulations regarding the use of a DCL that were inconsistent with the policies underlying IRC section 1503(d).[44] Thus, the 2005 proposed regulations provided a new rule based on ''foreign use.''[45]

Under the 2005 proposed regulations, a foreign use was deemed to occur only if two conditions were satisfied.[46] The first condition was satisfied if any portion of a loss or deduction taken into account in computing the DCL was made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that was recognized as income

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] 2006-8 IRB 496.

[38] *Id.*

[39] *Id.*

[40] 2007 reg. section 1.1503(d)-1(c).

[41] 1992 reg. section 1.1503-2(g)(2)(i)(E). This election was commonly referred to as a ''-2(g)(2) election.'' The 2005 proposed regulations changed the name of the election to a ''domestic use election.'' The 2007 final regulations retained that new name.

[42] 1992 reg. section 1.1503-2(g)(2)(iii)(A). Commonly referred to as a ''triggering event.''

[43] *See supra* note 11.

[44] *Id.*

[45] *See* the preamble to REG-102144-04 and 2005 prop. reg. section 1.1503(d)-1(b)(14)(i) and (ii).

[46] *Id.*

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or gain under the foreign laws (including items of income or gain generated by the DRC or separate unit itself), regardless of whether income or gain was actually offset and regardless of whether the items were recognized under U.S. tax principles.[47] The second condition was satisfied if items that were (or could be) offset under the first condition were considered, under U.S. tax principles, to be items of: (1) a foreign corporation or (2) a direct or indirect (such as through a partnership) owner of an interest in a hybrid entity, if that interest was not a separate unit.[48]

The 2005 proposed regulations contained three exceptions to the definition of a foreign use:

- when the laws of a foreign country provide an election that would enable a foreign use, a foreign use was considered to have occurred only if that election was made;
- if the DCL was made available under the laws of a foreign country both to offset income that would constitute a foreign use and to offset income that would not constitute a foreign use, and the laws of the foreign country did not provide rules for determining which income is offset by the DCL, the DCL was deemed to have been made available to first offset income that did not constitute a foreign use to the extent of that income; and
- DCLs attributable to: interests in a hybrid entity partnership or a hybrid entity grantor trust, indirectly owned separate units, and combined separate units.[49]

After considering various comments, the IRS and Treasury believed that it was appropriate to include some safe harbors when a foreign use was deemed *not* to occur.[50] Therefore, the 2007 final regulations set forth the following additional exceptions to the definition of a foreign use:

- when a DCL is made available solely as a result of a de minimis reduction in the domestic owner's interest in the separate unit (subject to the limitations specified in the regulations);
- when a DCL is made available as a result of the transfer of assets of a DRC or separate unit if specific percentages of basis and transfer periods are met;
- when a DCL is made available following the assumption of liabilities of a DRC or separate unit, if the availability results solely from a DCL incurred in connection with, or as a result of, the liabilities; and
- in some cases, when an unaffiliated domestic corporation or a new consolidated group acquires more than 90 percent (but less than 100 percent) of the transferred assets of a DRC or the transferred assets or interests in a separate unit, no foreign use will be considered to occur for a DCL attributable to the less than 10 percent acquisition of the DRC's assets or separate unit's assets or interest by persons other than the entity that acquired more than 90 percent.[51]

New Exception to Mirror Rule

The 1992 final regulations contained the infamous ''mirror rule'' that denied a taxpayer the ability to make an election to use a DCL when the foreign country had enacted legislation that operated in a manner similar to IRC section 1503(d), and as a result, prohibited the taxpayer from claiming the DCL in the foreign country. The mirror rule was designed to prevent the revenue gain resulting from the disallowance of a double dip from inuring solely to the foreign country.

The 2005 proposed regulations retained the mirror rule, but modified the rule to clarify that:

- the mere existence of a mirror rule (regardless of whether it applied to a particular DRC) might not have resulted in a deemed foreign use; and
- the absence of an affiliate in the foreign jurisdiction, or the failure to have made an election to enable a foreign use, did not prevent the opportunity for a foreign use.[52]

Several commentators encouraged the IRS and Treasury to pursue bilateral agreements when a DCL is disallowed in both the United States and the foreign country. The IRS and Treasury agreed that those agreements are necessary and that the agreements would appropriately refine and limit the scope of the mirror rule.[53]

[47] *Id.*

[48] *Id.*

[49] 2005 prop. reg. section 1.1503(d)-1(b)(14)(iii).

[50] *See* the preamble to T.D. 9315, *supra* note 13.

[51] 2007 reg. section 1.1503(d)-3(c)(5)-(8). These exceptions generally apply in cases when the potential for foreign use is de minimis, or when the transaction giving rise to a foreign use occurs as a result of events largely outside of the taxpayer's control.

[52] For example, the mirror rule could apply even if there were no affiliates of the DRC in the foreign jurisdiction or, even when there was such an affiliate, no election was made to consolidate. *See* the preamble to REG-102144-04 and 2005 prop. reg. section 1.1503(d)-5(c), examples 21 through 24.

[53] Note that Treasury concluded a competent authority agreement on such matters with the United Kingdom on October 6, 2006. *See* the preamble to T.D. 9315, *supra* note 13. The agreement applied to DCLs attributable to some U.K. permanent establishments that were otherwise subject to both IRC section

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Also, commentators suggested that a ''stand-alone'' exception to the mirror legislation rule be adopted.[54] Under the stand-alone exception, the mirror rule will not apply if there is not a foreign affiliate to which the separate unit or DRC could put the DCL to a foreign use.[55] Thus, the mirror legislation would not result in the revenue loss inuring solely to the United States since it was factually impossible for the loss to offset taxable income in the foreign country that was not also taken into account in the United States.[56] The IRS and Treasury agreed with this comment, and the 2007 final regulations contain a stand-alone exception to the mirror rule.[57]

Elimination of Basis Adjustment Rules

1992 reg. section 1.1503-2(d)(3) contained special basis adjustment rules that overrode the normal investment adjustment rules of reg. section 1.1503-32 for stock of affiliated DRCs and affiliated domestic owners owned by other members of the consolidated group. These special basis adjustment rules were included in the 1992 final regulations to prevent the indirect deduction of a DCL.[58] Although the 2005 proposed regulations retained the special basis adjustment rules, the IRS and Treasury requested comments on whether the special basis adjustment rules should be retained.[59]

Some commentators recommended that the special basis adjustment be removed for several reasons.[60] For example, the commentators noted that an indirect use, which the special basis adjustment rules were intended to prevent, may not occur for many years after the DCL was incurred.[61] In response to these comments, the special basis adjustment rules were eliminated with the 2007 final regulations.[62] With the 2007 final regulations, the normal basis adjustment rules of reg. section 1.1502-32 apply without modification for determining the adjusted basis in the stock of a DRC or the stock of the affiliated domestic owner owned by other members of the consolidated group.[63]

Certification Period

Under the 1992 final regulations, if a taxpayer made a -2(g)(2) election, it was required to certify in each of the 15 years following the year of the election that a triggering event had not occurred.[64] Believing that the 15-year certification period was unnecessarily burdensome to both taxpayers and the IRS, the 2005 proposed regulations reduced the certification period from 15 years to 7 years but expanded the annual certification requirement to include DCLs of foreign branch separate units.[65]

Commentators recommended that the certification period in the proposed regulations be further reduced to five years because the five-year period would be sufficient to deter the types of double dips with which IRC section 1503(d) is concerned, and would be consistent with periods used under similar provisions (for example, the term of gain recognition agreements entered into under IRC section 367(a)). Incredibly, the IRS and Treasury agreed with this comment, and as a result, the certification period in the 2007 final regulations is five years.[66] Importantly, the 2007 final regulations make the five-year certification period applicable to DCLs incurred before the effective date of the regulations, which resulted in tens of thousands (if not millions) of certification periods closing with the 2007 final regulations.[67]

Conclusion

As noted above, there has been a remarkable, taxpayer-friendly evolution of the DCL regulations with the 2005 proposed regulations and the 2007 final regulations. This evolution has included the expansion, elimination, and substitution of several key provisions found in the 1992 final regulations that greatly enhance taxpayers' ability to comply with the DCL regime, and should eliminate many of the inadvertent errors caused by the 1992 final regulations. ◆

1503(d) and mirror legislation enacted by the United Kingdom. In general, the agreement provided that taxpayers could elect to use or relieve the loss in either the United Kingdom or the United States, but not both. Also, the IRS and Treasury determined that the provisions of the agreement can serve as a model for future competent authority agreements, if necessary, between the United States and its treaty partners, which would further the congressional intent regarding the application of the mirror legislation rule. Accordingly, comments have been requested on the provisions of the agreement and on specific jurisdictions and considerations that should be taken into account in future agreements.

[54]*See* the preamble to T.D. 9315, *supra* note 13.

[55]*Id.*

[56]*Id.*

[57]2007 reg. section 1.1503(d)-3(e)(2).

[58]*See* preamble to T.D. 9315, *supra* note 13.

[59]*Id.*

[60]*Id.*

[61]*Id.*

[62]*Id.*

[63]*Id.*

[64]1992 reg. section 1.1503-2(g)(2)(iii)(A).

[65]2005 prop. reg. section 1.1503(d)-4(d)(1)(v).

[66]2007 reg. section 1.1503(d)-1(b)(20).

[67]2007 reg. section 1.1503(d)-8(b)(1).

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