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Internal Revenue Service
Memorandum

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to: Michael P. Corrado, Area Counsel, Heavy Manufacturing and Transportation

from: Associate Chief Counsel (International)

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subject: Dual Consolidated Losses: Reasonable Cause Requests Relating to Periods Where Assessment of Tax Under Section 6501(a) Is Not Permitted

This Chief Counsel Advice responds to your request for assistance regarding certain reasonable cause requests with respect to dual consolidated losses (DCLs) that are subject to section 1503(d) and Treas. Reg §§1.1503(d)-1 through -8, or Treas. Reg. §1.1503-2.[1]

ISSUE

Should the Area Director, Field Examination, Small Business/Self Employed or the Director of Field Operations, Large and Mid-Size Business (Director), as applicable,

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[1] The IRS and Treasury Department issued regulations under section 1503(d) in March 2007 ("2007 regulations"). T.D. 9315. Unless otherwise specified, all references herein are to the 2007 regulations. The 2007 regulations generally apply to DCLs incurred in taxable years beginning on or after April 18, 2007, although taxpayers may elect to have the 2007 regulations apply to taxable years beginning on or after January 1, 2007. The IRS and Treasury Department issued regulations under section 1503(d) in 1992 ("1992 regulations") which generally apply to DCLs incurred in taxable years beginning before the 2007 regulations apply. T.D. 8434. Prior to the reasonable cause procedure set forth in the 2007 regulations, taxpayers seeking to cure untimely filings under the 1992 regulations sought relief under the procedures in Treas. Reg. §301.9100-3. However, the 2007 regulations provide that the reasonable cause procedures apply to all untimely filings with respect to DCLs, including DCLs subject to the 1992 regulations. Treas. Reg. §1.1503(d)-8(b)(3)(i). Thus, this Chief Counsel Advice applies to reasonable cause determinations with respect to filings related to DCLs that are subject to Treas. Reg. §1.1503-2 and Treas. Reg. §§1.1503(d)-1 through 8.

consider in the following three scenarios a reasonable cause request under Treas. Reg. §1.1503(d)-1(c) with respect to DCLs incurred in a taxable year for which the period for assessment and collection of tax has expired under the rules of section 6501(a)?[2]

SCENARIOS

Presumed Facts

For purposes of the three scenarios described below, unless otherwise indicated, the following facts are presumed:

i. All DCLs are subject to Treas. Reg. §§1.1503(d)-1 through -8.
ii. USP is a domestic corporation that files a U.S. income tax return on a calendar year basis.
iii. USP wholly owns DE_X, an entity incorporated under the laws of Country X that is disregarded as an entity separate from its owner for Federal tax purposes. DE_X carries on business operations in Country X that, if carried on by a domestic corporation, would constitute a foreign branch as defined in Treas. Reg. §1.367-6T(g)(1). USP's interest in DE_X constitutes a hybrid entity separate unit,[3] and the branch operations conducted by DE_X in Country X constitute a foreign branch separate unit.[4] These two individual separate units are combined and treated as one separate unit (Separate Unit).[5]
iv. The exceptions to the domestic use limitation rule under Treas. Reg. §1.1503(d)-4(b), including the domestic use election under Treas. Reg. §1.1503(d)-6(d), do not apply to DCLs attributable to Separate Unit. Notwithstanding the domestic use limitation rule, and the fact that no exceptions apply thereto, the IRS did not disallow DCLs that were put to a domestic use.
v. USP does not have any net operating loss carryovers or carrybacks, as described in section 172.
vi. None of the exceptions to the general rule regarding limitations on assessment and collection under section 6501(a) apply.
vii. The period for assessment and collection of tax under the rules of section 6501(a) has expired for certain years (closed years) and has not expired for other years (open years).[6]

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[2] This Chief Counsel Advice only addresses the issue of whether such reasonable cause requests should be considered. It does not address whether any other type of reasonable cause request should be considered. It also does not address whether DCL reasonable cause requests that are considered should be granted or denied. The determination of whether DCL reasonable cause requests that are considered should be granted or denied is made by the Director in accordance with Treas. Reg. §1.1503(d)-1(c).
[3] Treas. Reg. §1.1503(d)-1(b)(4)(i)(B).
[4] Treas. Reg. §1.1503(d)-1(b)(4)(i)(A) and Treas. Reg. §1.1503(d)-1(b)(4)(iv).
[5] Treas. Reg. §1.1503(d)-1(b)(4)(ii).
[6] Solely for purposes of the issues addressed in this Chief Counsel Advice, the taxpayer's determination as to whether a taxable year is open or closed should be accepted, unless the Director can reasonably conclude otherwise based on all the relevant facts and circumstances

Scenario 1

A DCL is attributable to Separate Unit in years 1 and 2. USP did not timely file domestic use elections or related annual certifications with respect to the year 1 or year 2 DCL. Notwithstanding the domestic use limitation, USP used the entire year 1 DCL to offset domestic affiliate income on USP's income tax return for year 1, and used the entire year 2 DCL to offset domestic affiliate income on USP's income tax return for year 2.

In year 5, USP requests reasonable cause relief for the failure to timely file a domestic use election for the year 1 and year 2 DCLs, and related annual certifications. At the time the reasonable cause requests are made, year 1 is a closed year and years 2 through 4 are open years.

Scenario 2

A DCL is attributable to Separate Unit in year 1. USP timely filed a domestic use election with respect to the year 1 DCL and USP used the entire year 1 DCL to offset domestic affiliate income on its income tax return for year 1. USP did not timely file annual certifications with respect to the year 1 DCL in years 2 through 5. USP did not recapture the year 1 DCL in year 2.

In year 6, USP requests reasonable cause relief for the failure to timely file the annual certifications for the year 1 DCL. At the time the reasonable cause requests are made, years 1 and 2 are closed years, and years 3 through 5 are open years.

Scenario 3

A DCL is attributable to Separate Unit in year 2. USP did not timely file a domestic use election or related annual certifications with respect to the year 2 DCL. Notwithstanding the domestic use limitation, USP used the entire year 2 DCL to offset domestic affiliate income on USP's income tax return for year 2.

USP has an NOL that was incurred in year 1 and, after the application of section 172(b), is carried forward to year 6. The year 1 NOL carried forward to year 6 is in excess of the year 2 DCL.

In year 6, USP requests reasonable cause relief for the failure to timely file the domestic use election for the year 2 DCL and related annual certifications. At the time the reasonable cause requests are made, year 2 is a closed year, but years 3 through 5 are open years.

LAW AND ANALYSIS

Subject to certain exceptions, section 1503(d) and the regulations thereunder prevent a DCL from being made available to offset, directly or indirectly, the income of a domestic affiliate (domestic use).[7] A domestic use occurs in the taxable year when the DCL is included in the computation of taxable income, even if no tax benefit results from such inclusion in that year.[8]

A DCL is a net operating loss of a dual resident corporation or the net loss attributable to a separate unit.[9]

A taxpayer may elect to use a DCL to offset a domestic affiliate's income if the taxpayer timely makes a domestic use election.[10] If a domestic use election is timely made and a triggering event occurs (and no exception applies) during the certification period, the taxpayer must generally recapture and report as gross income the total amount of the DCL on its U.S. income tax return for the taxable year in which the triggering event occurs, plus an applicable interest charge.[11] The certification period is the period of time up to and including the fifth taxable year following the year in which the DCL was incurred.

A taxpayer making a domestic use election must file an annual certification with its income tax return for each of the five taxable years subsequent to the year in which the DCL is incurred providing, among other things, that there has been no recapture of the DCL.[12] Failure to timely file a certification constitutes a triggering event.[13]

Taxpayers that have failed to timely make certain filings under the DCL regulations, including the domestic use election and the annual certifications, may generally attempt to cure the delinquency by demonstrating reasonable cause.[14] If the Director determines that the taxpayer had reasonable cause for its failure to timely file, the filing will be considered timely.[15]

Subject to certain exceptions, an amount of income tax for a taxable period may be assessed only within three years after the income tax return for that period was filed.[16]

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[7] Treas. Reg. §§1.1503(d)-2 and -4(b).
[8] Treas. Reg. §1.1503(d)-2.
[9] *See* Treas. Reg. §1.1503(d)-1(b)(5).
[10] Treas. Reg. §1.1503(d)-6(d).
[11] Treas. Reg. §1.1503(d)-6(h). A taxpayer may not make a domestic use election if a foreign use triggering event occurs in the year in which the DCL was incurred, or in any prior year. *See* Treas. Reg. § 1.1503(d)-6(d)(2).
[12] Treas. Reg. §1.1503(d)-6(g). If a taxpayer does not make a domestic use election with respect to a DCL, the taxpayer is not obligated to file annual certifications.
[13] Treas. Reg. §1.1503(d)-6(e)(1)(viii).
[14] Treas. Reg. §1.1503(d)-1(c).
[15] *Id*.
[16] Section 6501(a).

CONCLUSIONS

Scenario 1

USP used the year 1 DCL to offset domestic affiliate income, which is contrary to the domestic use limitation. As a result, the IRS should have disallowed the year 1 DCL and assessed any resulting additional income tax within the period specified by section 6501(a). Even though the year 1 DCL certification period includes open years, there can be no triggering event that would result in recapture income (and interest) because a domestic use election had not been filed with respect to the DCL. Accordingly, the IRS cannot assess additional income tax with respect to the year 1 DCL, or any related recapture income (or interest), for any open years. Therefore, the Director should not accept for consideration USP's request for reasonable cause relief to file a domestic use election or annual certifications with respect to the year 1 DCL.

USP also used the year 2 DCL to fully offset domestic affiliate income, contrary to the domestic use limitation. However, the IRS may disallow the year 2 DCL and assess any resulting additional income tax because year 2 is an open year. That is, the IRS can make an assessment of tax by determining USP's additional liability if the year 2 DCL were not allowed to offset domestic affiliate income. Therefore, the Director should accept for consideration USP's request for reasonable cause relief to file a domestic use election and annual certifications with respect to the year 2 DCL.

Scenario 2

USP timely filed a domestic use election for the year 1 DCL and, as a result, the DCL was not subject to the domestic use limitation. However, the year 1 DCL was triggered in year 2 as a result of USP failing to timely file the year 2 certification.[17] Nevertheless, USP failed to include in its year 2 income the recapture income (and interest). As a result, the IRS should have adjusted USP's year 2 taxable income to include the recapture income (and interest) within the period specified by section 6501(a). Even though the year 1 DCL certification period includes open years, there can be no additional triggering events that would result in recapture income (and interest) in such open years because the domestic use election terminated as a result of the year 2 triggering event.[18] Therefore, the Director should not accept for consideration USP's request for reasonable cause relief to file annual certifications with respect to the year 1 DCL.

Scenario 3

[17] Treas. Reg. §1.1503(d)-6(e)(1)(viii).
[18] Treas. Reg. §1.1503(d)-6(j)(1)(iii).

USP used the year 2 DCL to offset domestic affiliate income, which is contrary to the domestic use limitation. As a result, the IRS should have disallowed the year 2 DCL and assessed any resulting income tax within the period specified by section 6501(a). Even though the year 2 DCL certification period includes open years, there can be no triggering event that would result in recapture income (and interest) because a domestic use election had not been filed with respect to the DCL. However, and notwithstanding year 2 being a closed year, the IRS may effectively disallow the domestic use of the year 2 DCL by recomputing and reducing the amount of the NOL carryforward available in year 3 and subsequent open years.[19] The NOL carryforward would be reduced since the year 2 DCL would be subject to the domestic use limitation and the NOL carryforward, rather than the year 2 DCL, would have been used to offset year 2 income. Because disallowing the DCL would affect tax liability in an open year, the Director should accept for consideration USP's request for reasonable cause relief to file a domestic use election and related annual certifications with respect to the year 2 DCL.[20]

Please call (202) 622-3860 if you have any further questions.

[19] *See, e.g.*, *Phoenix Coal Co., Inc. v. Commissioner*, 231 F.2d 420 (2d Cir. 1956) (where statute of limitations had expired for 1945 but not 1946, recomputation of 1945 income by reducing deductions was permissible to determine how much of a 1947 net operating loss could be carried back to 1946 and assessing deficiency for 1946).

[20] Alternatively, if a DCL incurred in a closed year entered into the calculation of an NOL for that year, the IRS could also reduce the amount of the NOL carryforward by effectively disallowing the DCL. In such a case, the Director should accept for consideration a request for reasonable cause relief.