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subject: Dual Consolidated Losses: Application of SRLY Rules

FACTS

USP is a domestic corporation and the common parent of an affiliated group of corporations that files a consolidated federal income tax return on a calendar-year basis ("the USP group"). USP owns USS, a domestic corporation and member of the USP group. USS owns 100% of the interests in FEX. FEX is an entity organized under the laws of Country X that is subject to Country X income tax on its worldwide income but is disregarded as an entity separate from USS for federal tax purposes. FEX files its Country X income tax return on a calendar-year basis.

FEX carries on a business operation in Country X that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of Treas. Reg. §1.367(a)-6T(g)(1).

USS's interest in FEX constitutes a hybrid entity separate unit within the meaning of Treas. Reg. §1.1503(d)-1(b)(4)(i)(B), and USS's indirect interest in its share of the business operations conducted by FEX constitutes a foreign branch separate unit within the meaning of Treas. Reg. §1.1503(d)-1(b)(4)(i)(A). These two individual separate units are combined and treated as a single separate unit under Treas. Reg. § 1.1503(d)-1(b)(4)(ii) ("FEX Separate Unit").

USS has conducted business operations in Country X through the FEX Separate Unit since January 1, Year 1. In Year 1, USS generates $120x of net income that is attributable to the FEX Separate Unit pursuant to Treas. Reg. § 1.1503(d)-5. In Year 2, USS incurs a net loss of $100x that is attributable to the FEX Separate Unit. USS has no other items of income or loss for Years 1 and 2. The taxable income attributable to the USP group (without taking into account those items of income or loss attributable to the FEX Separate Unit) for Year 1 and Year 2 is $300x and $150x, respectively.

The $100x net loss attributable to the FEX Separate Unit in Year 2 is a dual consolidated loss ("DCL"). The USP group does not make a domestic use election with respect to the FEX Separate Unit's DCL ("the FEX DCL") under Treas. Reg. § 1.1503(d)-6(d), and no other exceptions in Treas. Reg. § 1.1503(d)-6 apply. Accordingly, the FEX DCL is subject to the domestic use limitation rule of Treas. Reg. § 1.1503(d)-4.

Alternative

The facts are the same as above, except that in Year 1 USS generates only $60x of net income that is attributable to the FEX Separate Unit.

ISSUE

Whether the FEX DCL is taken into account to offset USP's income in determining the USP group's consolidated taxable income ("CTI") in Year 2.[1]

LAW

A DCL is a net operating loss of a dual resident corporation or the net loss attributable to a separate unit under Treas. Reg. § 1.1503(d)-5(c) through (e).[2]

Subject to certain exceptions, including a domestic use election described below, section 1503(d) and the regulations thereunder prevent the "domestic use" of a DCL. A domestic use of a DCL is deemed to occur when the DCL is made available to offset, directly or indirectly, the income of a domestic affiliate in the year in which the DCL is

[1] All taxable years at issue are subject to Treas. Reg. §§ 1.1503(d)-1 through -8 under Treas. Reg. § 1.1503(d)-8(a). The IRS and Treasury Department issued final regulations under section 1503(d) in March 2007 (the "2007 regulations"). T.D. 9315, 2007-1 C.B. 891, 72 Fed. Reg. 12902 (March 19, 2007). All references herein are to the 2007 regulations, unless otherwise noted. 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 in their entirety apply to taxable years beginning on or after January 1, 2007. Treas. Reg. § 1.1503(d)-8(a). The IRS and Treasury Department issued regulations under section 1503(d) in 1992 (the "1992 regulations") which generally apply to DCLs incurred in taxable years beginning before the 2007 regulations apply. T.D. 8434, 1992-2 C.B. 240, 57 Fed. Reg. 41079 (Sept. 9, 1992).

[2] Treas. Reg. § 1.1503(d)-1(b)(5). *See* Treas. Reg. § 1.1503(d)-5(b)(2) for certain items that are not taken into account for purposes of determining the income or DCL of a dual resident corporation.

recognized or in any other taxable year. In addition, a domestic use occurs in the taxable year when the DCL is included in the computation of taxable income of a consolidated group, even if no tax benefit results from such inclusion in that year.[3]

A separate unit generally means either of the following that is carried on or owned, directly or indirectly, by a domestic corporation: (1) a business operation outside the United States that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of Treas. Reg. § 1.367(a)-6T(g)(1) (foreign branch separate unit); or (2) an interest in a hybrid entity (hybrid entity separate unit).[4] Certain separate units are combined and treated as a single separate unit.[5]

A domestic owner generally is a domestic corporation that has one or more separate units.[6] An affiliated domestic owner is a domestic owner which is a member of a consolidated group.[7]

Treas. Reg. § 1.1503(d)-4(a) provides that when the domestic use limitation applies, a DCL is subject to the separate return limitation year (SRLY) provisions of Treas. Reg. § 1.1502-21(c), as modified by Treas. Reg. § 1.1503(d)-4. Treas. Reg. § 1.1503(d)-4(b) generally provides that the domestic use of a DCL is not permitted. Treas. Reg. § 1.1503(d)-4(c)(2) provides the rules that apply for any taxable year in which a DCL that is attributable to a separate unit is subject to the domestic use limitation.

Treas. Reg. § 1.1503(d)-4(c)(2) provides:

> This paragraph (c)(2) applies to a dual consolidated loss that is attributable to a separate unit. The unaffiliated domestic owner of a separate unit, or the consolidated group of an affiliated domestic owner of a separate unit, shall compute its taxable income (or loss) or consolidated taxable income (or loss), respectively, without taking into account those items of deduction and loss that compose the separate unit's dual consolidated loss. For this purpose, the dual consolidated loss shall be treated as composed of a pro rata portion of each item of deduction and loss of the separate unit taken into account in computing the dual consolidated loss. The dual consolidated loss is subject to the limitations contained in paragraph (c)(3) of this section as if the separate unit to which the dual consolidated loss is attributable were a separate domestic

[3] Treas. Reg. § 1.1503(d)-2.

[4] Treas. Reg. § 1.1503(d)-1(b)(4)(i).

[5] Treas. Reg. § 1.1503(d)-1(b)(4)(ii).

[6] Treas. Reg. § 1.1503(d)-1(b)(9). For purposes of section 1503(d), the term "domestic corporation" has the meaning provided in section 7701(a)(3) and (4), but excludes regulated investment companies, real estate investment trusts and S corporations. For purposes of this memorandum, references to domestic corporations have the meaning provided in Treas. Reg. § 1.1503(d)-1(b)(1).

[7] Treas. Reg. § 1.1503(d)-1(b)(10).

> corporation that filed a consolidated return with its unaffiliated domestic owner or with the consolidated group of its affiliated domestic owner, as applicable. Subject to such limitations, the dual consolidated loss may be carried over or back for use in other taxable years as a separate net operating loss carryover or carryback of the separate unit arising in the year incurred. See § 1.1503(d)-7(c), *Examples 29 and 38.*

If the use of a DCL is restricted by the domestic use limitation rule, Treas. Reg. § 1.1503(d)-4(c)(3) provides that "the dual consolidated loss shall be treated as a loss incurred by the dual resident corporation or separate unit in a separate return limitation year and shall be subject to all of the limitations of § 1.1502-21(c) (SRLY Limitation)," with certain modifications.

A separate return year and a separate return limitation year are each defined in Treas. Reg. § 1.1502-1:

> (e) Separate return year. -- The term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.
>
> (f) Separate return limitation year. -- (1) In general. Except as provided in paragraphs (f)(2) and (3) of this section, the term separate return limitation year (or SRLY) means any separate return year of a member or of a predecessor of a member.

Treas. Reg. § 1.1502-21(c)(1)(i) provides the general limitation on including net operating losses of members arising in separate return limitation years ("SRLYd NOLs") in the consolidated NOL ("CNOL") deduction for the year. Under the SRLY rules, the aggregate amount of a member's SRLYd NOL absorbed by a group as of the end of a consolidated return year may not exceed the member's aggregate contribution to the group's CTI as of the end of the year. In particular, the rule provides:

> [T]he aggregate of the net operating loss carryovers and carrybacks of a member arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group under paragraph (a) of this section may not exceed the aggregate consolidated taxable income for all consolidated return years of the group *determined by reference to only the member's items of income, gain, deduction, and loss* . . . (emphasis added).[8]

Treas. Reg. § 1.1502-15(a) generally provides that "built-in losses are subject to the SRLY limitation under §§ 1.1502-21(c) and 1.1502-22(c)," and that "[b]uilt-in losses are treated as deductions or losses in the year recognized, except for the purpose of determining the amount of, and the extent to which the built-in loss is limited by, the

[8] Treas. Reg. § 1.1502-21(c)(1)(i).

SRLY limitation for the year in which it is recognized." Treas. Reg. § 1.1502-21(c)(1)(i)(D) states that for SRLY purposes, "[t]he treatment under § 1.1502-15 of a built-in loss as a hypothetical net operating loss carryover in the year recognized is solely for purposes of determining [the SRLY limitation] with respect to the loss in that year and not for any other purpose."

Treas. Reg. § 1.1503(d)-6(d) provides in part that "[t]he domestic use limitation rule of § 1.1503(d)-4(b) shall not apply to a dual consolidated loss if an election to be bound by the provisions of paragraphs (d) through (j) of this section is made by the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be (elector)."

ANALYSIS AND CONCLUSIONS

Because none of the exceptions in Treas. Reg. § 1.1503(d)-6 apply, the FEX DCL is subject to the domestic use limitation of Treas. Reg. § 1.1503(d)-4(b). Thus, the USP group may only use the FEX DCL to the extent permitted under Treas. Reg. § 1.1503(d)-4(c)(2).[9]

Treas. Reg. § 1.1503(d)-4(c)(2) (quoted above) describes the effect of the domestic use limitation on a DCL attributable to a separate unit. The second sentence of that paragraph requires CTI to be computed without taking into account those items of deduction and loss that compose the DCL, thus segregating the DCL from the rest of the group's items. The fourth sentence of that paragraph sets forth the operative rule that subjects the DCL to the SRLY limitation of Treas. Reg. § 1.1503(d)-4(c)(3) (and thus the SRLY limitation of Treas. Reg. § 1.1502-21(c)). The fifth sentence of that paragraph further provides that, subject to the limitations of Treas. Reg. § 1.1503(d)-4(c)(3), the DCL may be carried over or back for use in other taxable years. As will be discussed, under the operative rule of the fourth sentence a DCL incurred by a separate unit in the current year may be absorbed as an offset to income of the affiliated domestic owner in that year to the extent of the separate unit's cumulative prior contributions to CTI. The fifth sentence provides for additional use of the DCL (not so absorbed) as a carryforward or carryback.

The SRLY limitation of Treas. Reg. § 1.1503(d)-4(c)(3) provides that the DCL generally is subject to all of the provisions of the Treas. Reg. § 1.1502-21(c) SRLY limitation. The SRLY limitation of Treas. Reg. § 1.1502-21(c) incorporates a concept known as the "cumulative register" (or "SRLY register"). Under this rule, the consolidated group may use a SRLYd NOL (subject to several limitations) to offset CTI to the extent that the SRLY member has contributed to the *cumulative* CTI of the group during consolidated

[9] Because USS is an affiliated domestic owner, the discussion of the domestic use limitation rule in this memorandum will generally refer only to a situation involving a separate unit that is carried on or owned by a member of a consolidated group. However, the principles underlying the discussion herein apply equally to DCLs of a dual resident corporation and DCLs attributable to a separate unit that is carried on or owned by an unaffiliated domestic owner, as provided in Treas. Reg. § 1.1503(d)-4(c)(1) and (c)(2).

return years.[10] In contrast, under the prior rule, the SRLY limitation was based on the SRLY member's contribution to CTI *for the year*, and thus, by definition, a SRLYd NOL could not be used to offset CTI in any year in which the SRLY member had a loss.[11]

The DCL regulations, in describing the applicability of the SRLY limitation, do not explicitly adopt the cumulative register concept. However, the cumulative register concept predates the issuance of the final DCL regulations in 2007.[12] Because the DCL regulations fully incorporate the SRLY limitation (except for the modifications provided in paragraph (c)(3)), the cumulative register concept applies to DCLs made subject to the domestic use limitation.[13]

The issue here is whether the FEX DCL is taken into account when computing CTI in Year 2. Thus, it is necessary to consider whether the application of the SRLY rules to a DCL subject to the domestic use limitation rule may, in certain cases, allow the DCL to be used to offset income of a domestic affiliate in the year the DCL is incurred.

Generally, a SRLYd NOL cannot be used to offset CTI in the year incurred because, by definition, the loss would have arisen in a separate return limitation year. Therefore, such losses can only be used as carrybacks or carryforwards. This practical limitation does not exist in the DCL context, however, as a DCL can arise in any year, including those years when the member is included in a consolidated group.

As discussed above, Treas. Reg. § 1.1503(d)-4(c)(2) permits a consolidated group to take into account a DCL to the extent the loss would be allowable as a SRLYd loss under Treas. Reg. § 1.1502-21(c). When the consolidated group takes into account the DCL pursuant to Treas. Reg. § 1.1503(d)-4(c) and the SRLY rules, this constitutes a domestic use of the DCL described in Treas. Reg. § 1.1503(d)-2. A domestic use is deemed to occur when the DCL is "made available to offset . . . the income of a domestic affiliate . . . *in the taxable year in which the dual consolidated loss is recognized*, or in any other taxable year" (emphasis added). This presumption that a domestic use first occurs in the year the DCL is recognized supports a similar construction of Treas. Reg. § 1.1503(d)-4(c). Thus, the language in Treas. Reg. § 1.1503(d)-4(c)(2) allowing carryovers or carrybacks of a DCL subject to the domestic

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[10] Treas. Reg. § 1.1502-21(c)(1)(i).

[11] Treas. Reg. § 1.1502-21A(c).

[12] *See* Temp. Treas. Reg. § 1.1502-21T(c)(1), added by T.D. 8677, 61 Fed. Reg. 33321, 33329 (June 27, 1996) (effective for consolidated return years beginning on or after January 1, 1997). These regulations were replaced with final regulations in T.D. 8823, 1999-2 C.B. 34, 64 Fed. Reg. 36092 (July 2, 1999).

[13] The cumulative register concept is implicitly referenced in Treas. Reg. § 1.1503(d)-4(c)(3)(iii), which provides that the calculation of the separate unit's aggregate consolidated taxable income shall only include income arising in the same foreign country as the DCL. The concept also is applied in Example 40 of Treas. Reg. § 1.1503(d)-7(c), where the recapture of a DCL for which a domestic use election was made was reduced, under Treas. Reg. § 1.1503(d)-6(h)(2)(i), by the amount of the DCL that would have been usable as a result of the separate unit's cumulative register.

use limitation may be interpreted as providing that a DCL may be carried back or forward to the extent that it is not used in the current year. In other words, under the SRLY rules, if a member incurs a DCL after having contributed to CTI in prior years, the DCL may be absorbed currently as an offset to income of domestic affiliates in the year of the DCL (limited by the amount of the member's prior CTI contributions).

In addition, Treas. Reg. § 1.1502-15(a) provides precedent for permitting a loss subject to the SRLY limitation to be used in the year recognized in an analogous context. Under this provision, to the extent a built-in loss[14] is allowed as a deduction in the taxable year in which it is recognized—*i.e.*, to the extent there is an available positive balance in the cumulative register in the recognition year—the built-in loss is not limited and is deducted (and reduces CTI) for the year. To the extent the recognized built-in loss exceeds the cumulative register for that year, the loss is treated as a separate NOL arising in the recognition year (which is treated as a SRLY) that may be carried over or back.[15] These rules thus apply the SRLY rules and the cumulative register concept in a manner that allows a built-in loss to be used currently (to the extent of a positive cumulative register balance and current income of other members) before the loss is carried back or over to other taxable years. These rules are analogous to the DCL rules because a member that recognizes a built-in loss in a taxable year may find its loss segregated into a SRLY and subject to the SRLY limitations, even where the group has positive CTI for the year.

Allowing the USP group to offset Year 2 CTI with the FEX DCL is consistent with the policies underlying section 1503(d). In general, the DCL provisions are intended to prevent a "double-dip," in which a single economic loss is used to offset two streams of income —one reported on a U.S. tax return, and one reported on a foreign tax return and not subject to tax in the U.S.[16] Here, this concern is not present because the FEX DCL is in effect only offsetting the FEX Separate Unit's "own" income. That is, the FEX Separate Unit's positive cumulative register ensures that the FEX DCL will only be available to offset CTI to the extent the FEX Separate Unit has contributed to aggregate CTI in previous years. Thus, the policies underlying the rules of Treas. Reg. § 1.1503(d)-4 (and the rules of Treas. Reg. § 1.1502-21(c)) are satisfied to the extent that, at the time the FEX DCL is absorbed, the FEX Separate Unit has made a corresponding positive cumulative contribution to CTI.

Because the domestic use limitation rule allows the USP group to utilize the FEX DCL to the extent that use complies with the SRLY rules, and because use in the current year is consistent with both the regulatory language and policies underlying the DCL rules, the USP group may use the FEX Separate Unit's $100x DCL in determining CTI in Year 2. It is not necessary for the USP group to make a domestic use election under

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[14] As defined by Treas. Reg. § 1.1502-15(b)(1). In general, built-in losses are losses that economically accrued in a SRLY and are recognized in a consolidated return year.

[15] Treas. Reg. § 1.1502-15(a).

[16] Staff of Joint Comm. on Tax'n., 99th Cong., 2nd Sess., *General Explanation of the Tax Reform Act of 1986*, at 1064-1065 (Comm. Print 1987).

Treas. Reg. § 1.1503(d)-6(d) in order to utilize the FEX DCL. Thus, for Year 2, the USP group has $50x CTI, and the FEX Separate Unit has $20x cumulative register remaining.

Alternative

For the reasons stated above, the USP group may utilize the FEX DCL in Year 2 to the extent of the FEX Separate Unit's cumulative register. Because the FEX DCL exceeds FEX's cumulative register of $60x, only $60x of the $100x DCL may be utilized by the USP group. The remaining $40x of the FEX DCL remains subject to the domestic use limitation rule.

Alternatively, the USP group may file a domestic use election for the entire FEX DCL in Year 2, provided that the USP group is otherwise eligible to make the election and the requirements of Treas. Reg. § 1.1503(d)-6(d) are satisfied. However, USP may not file a domestic use election for a portion of the FEX DCL in addition to utilizing the FEX Separate Unit's cumulative register (*i.e.*, by filing the domestic use election only for the remaining $40x of the DCL). By their terms, Treas. Reg. §§ 1.1503(d)-1(b)(5)(ii) and 1.1503(d)-6(d) apply to the whole DCL and not just a portion thereof.[17] Accordingly, the USP group may utilize the FEX Separate Unit's cumulative register or file a domestic use election for the entire FEX DCL, but not both.[18]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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

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[17] I.e., Treas. Reg. § 1.1503(d)-1(b)(5)(ii) defines a DCL as "the net loss attributable to a separate unit under § 1.1503(d)-5(c) through (e)." (emphasis added)

[18] In the event USP filed a domestic use election and was later required to recapture the FEX DCL under Treas. Reg. § 1.1503(d)-6(h), USP may be entitled to offset the recapture amount by the FEX Separate Unit's cumulative register. Treas. Reg. §§ 1.1503(d)-6(h)(2)(i) and 1.1503(d)-7(c), Example 40.