subject: Dual Consolidated Losses: Definition of Foreign Use and Application of Exceptions

FACTS AND ISSUES

Presumed Facts

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

i. All dual consolidated losses (DCLs) are subject to Treas. Reg. §§1.1503(d)-1 through -8.¹

ii. USP is a domestic corporation that files a U.S. income tax return on a calendar year basis.

iii. FEX is an entity organized under the laws of Country X that is subject to Country X income tax on its worldwide income. FEX files its Country X income tax return on a calendar year basis.

iv. Under Country X laws, items of deduction or loss incurred by FEX in a taxable year are available to offset or reduce any item of income or gain incurred by FEX during such taxable year. Country X laws do not permit FEX to carry back losses to taxable years prior to the taxable year in which the losses were incurred.
v. One or more of the deductions or losses taken into account in computing all DCLs are recognized as deductions or losses under the laws of Country X.

vi. 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).

vii. For periods in which FEX is classified as a partnership or a disregarded entity for federal tax purposes, USP’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 USP’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 one separate unit (FEX Separate Unit).

Scenario 1:

USP has owned 100 percent of the stock of FEX since its formation on January 1, year 1. Prior to July 1, year 2, FEX was classified as a foreign corporation for federal tax purposes.

Effective as of July 1, year 2, FEX elected to be disregarded as an entity separate from its owner for federal tax purposes under Treas. Reg. §301.7701-3(a). The deemed distribution of FEX’s assets and liabilities to USP pursuant to Treas. Reg. §301.7701-3(g)(1)(iii) qualified as a complete liquidation to which section 332 applied.

A DCL is attributable to the FEX Separate Unit for the period from July 1, year 2, through December 31, year 2 (Year 2 DCL).

The issue is whether USP is permitted to make a domestic use election with respect to the Year 2 DCL.

Scenario 2:

USP has owned 100 percent of the stock of FEX since its formation on January 1, year 1. Effective as of the date of its formation, FEX elected to be disregarded as an entity separate from its owner for federal tax purposes under Treas. Reg. §301.7701-3(a).

A DCL is attributable to the FEX Separate Unit in year 1 (Year 1 DCL). USP timely filed a domestic use election with respect to the Year 1 DCL and such loss therefore was included in the computation of USP’s taxable income for year 1.

On January 1, year 3, USP sold for cash two percent of its interest in FEX to FC, an unrelated foreign corporation. Although this sale resulted in a foreign use of the Year 1 DCL as described in Treas. Reg. §1.1503(d)-3(a)(1), it did not constitute a foreign use
because it qualified for the de minimis exception provided under Treas. Reg. §1.1503(d)-3(c)(5).²

On June 30, year 3, FC transferred its two percent interest in FEX to FS, a foreign corporation wholly owned by FC. This transfer also resulted in a foreign use of the Year 1 DCL as described in Treas. Reg. §1.1503(d)-3(a)(1).

The issue is whether the de minimis exception applies to the June 30, year 3, transfer of the FEX interest from FC to FS such that no foreign use of the Year 1 DCL is considered to occur.

Scenario 3:

USP and USD, an unrelated domestic corporation, formed FEX on January 1, year 3. USP and USD each owned 50 percent of the interests in FEX. Effective as of the date of its formation, FEX elected to be classified as a partnership for federal tax purposes under Treas. Reg. §301.7701-3(a).

A DCL is attributable to the FEX Separate Unit in year 3 (Year 3 DCL).³ USP timely filed a domestic use election with respect to the Year 3 DCL and such loss therefore was included in the computation of USP’s taxable income for year 3.

On January 1, Year 5, USP sold for cash 20 percent of its interest in FEX (representing ten percent of the outstanding interests in FEX) to USD.

The issue is whether the January 1, year 5, sale of the FEX interest results in a foreign use of the Year 3 DCL pursuant to the last sentence of Treas. Reg. §1.1503(d)-3(c)(4)(iii).

LAW

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).⁴ 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.⁵

A DCL is a net operating loss of a dual resident corporation or the net loss attributable to a separate unit.⁶ For purposes of determining the amount of the income or DCL attributable to a separate unit for the taxable year, only the items of income, gain, deduction, and loss generated or incurred during the period the separate unit qualified as such shall be taken into account.⁷ For this purpose, the allocation of items to periods is made under the principles of Treas. Reg. §1.1502-76(b).⁸
A dual resident corporation is a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a residence basis.\(^9\) 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); and (2) an interest in a hybrid entity (hybrid entity separate unit).\(^10\) Certain separate units are combined and treated as a single separate unit.\(^11\)

A domestic owner generally is a domestic corporation that has one or more separate units.\(^12\) 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.\(^13\)

A hybrid entity means an entity that is not taxable as an association for Federal tax purposes, but is subject to an income tax of a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.\(^14\)

A domestic use of a DCL is permitted if a timely domestic use election is made, including the filing of a domestic use agreement.\(^15\) A domestic use agreement must include a certification that there has not been, and will not be, a foreign use during the certification period.\(^16\) In addition, an annual certification generally must be filed for each taxable year during the certification period.\(^17\)

The certification period is the period of time up to and including the fifth taxable year following the year in which the DCL that is the subject of a domestic use agreement was incurred.\(^18\)

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.\(^19\)

A domestic use election cannot be made if a triggering event occurs (and no exception applies) with respect to the DCL in the same taxable year in which the DCL is incurred.\(^20\) In addition, 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.\(^21\)

Subject to certain exceptions, a foreign use of a DCL is deemed to occur when two conditions are satisfied. First, any portion of a deduction or loss that is taken into account in computing the DCL must be 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.\(^22\) Second, the item of income described in the prior
sentence is, or would be, considered under U.S. tax principles, to be an item of a foreign corporation, or an item of a direct or indirect owner of an interest in a hybrid entity, provided the interest is not a separate unit.

A foreign use is deemed to occur in the year in which any portion of a deduction or loss taken into account in computing the DCL is made available for such an offset, regardless of whether it actually offsets or reduces any items of income or gain under the income tax laws of the foreign country in such year, and regardless of whether any of the items that may be so offset or reduced are regarded as income under U.S. tax principles.

Various exceptions to foreign use are provided under Treas. Reg. §1.1503(d)-3(c)(2) through (c)(8). One of these exceptions is provided under Treas. Reg. §1.1503(d)-3(c)(5) and applies with respect to a foreign use that occurs as a result of a de minimis reduction of an interest in a separate unit ("de minimis exception"). The de minimis exception generally provides that no foreign use shall be considered to occur as a result of an item of deduction or loss composing the DCL being made available solely as a result of certain reductions in the domestic owner's interest in the separate unit. The de minimis exception does not apply, however, if the domestic owner's percentage interest in the separate unit is reduced by more than a certain amount ("de minimis limitation"). Under the de minimis limitation, the de minimis exception shall not apply if the domestic owner's percentage interest in the separate unit is reduced by either: (1) 10 percent or more during any 12-month period, as determined by reference to the domestic owner's interest at the beginning of the 12-month period; or (2) 30 percent or more, as determined by reference to the domestic owner's interest at the end of the taxable year in which the DCL was incurred.

Treasury Reg. §1.1503(d)-3(c)(4) provides another exception to foreign use for certain interests in partnerships or grantor trusts ("(c)(4) exception"). The (c)(4) exception applies to a DCL attributable to an interest in a hybrid entity partnership or a hybrid entity grantor trust, or to a separate unit owned indirectly through a partnership or grantor trust. Under this exception, a foreign use will not be considered to occur if the foreign use is solely the result of another person's ownership of an interest in the partnership or grantor trust, as applicable, and the allocation or carry forward of an item of deduction or loss composing the DCL as a result of such ownership.

The (c)(4) exception is limited by Treas. Reg. §1.1503(d)-3(c)(4)(iii) ("(c)(4) limitation"), which provides:

The [(c)(4) exception] shall not apply if, at any time following the year in which the dual consolidated loss is incurred, there is more than a de minimis reduction in the domestic owner's percentage interest in the partnership or grantor trust, as applicable, as described in paragraph (c)(5) of this section. In such a case, a foreign use shall be deemed to occur at the time the reduction in interest exceeds the de minimis amount.
For purposes of both the de minimis exception and the (c)(4) exception, a reduction in interest may result from another person acquiring through a sale, exchange, contribution, or other means an interest in the foreign branch or hybrid entity.30

ANALYSIS AND CONCLUSIONS

Scenario 1

In this scenario, a foreign use of the Year 2 DCL would be deemed to occur if two conditions are satisfied. First, any portion of a deduction or loss taken into account in computing the Year 2 DCL must be 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.31 In this scenario, one or more of the deductions or losses taken into account in computing the Year 2 DCL are recognized as deductions or losses under the laws of Country X. In addition, under Country X laws such deductions or losses are available to offset any item of income or gain incurred by FEX during year 2. Thus, the first condition is satisfied.

Second, the item of income or gain that is able to be offset by a deduction or loss of the Year 2 DCL as described in the first condition is, or would be, considered under U.S. tax principles to be an item of a foreign corporation, or an item of a direct or indirect owner of an interest in a hybrid entity that is not a separate unit.32 As noted above, under Country X laws one or more of the items taken into account in computing the Year 2 DCL are made available to offset any item of income or gain incurred by FEX during year 2. Because FEX is classified as a foreign corporation under U.S. tax principles from January 1, year 2, through June 30, year 2, an item of income or gain able to be offset by a deduction or loss of the Year 2 DCL is or would be considered under U.S. tax principles to be an item of a foreign corporation. Thus, the second condition is satisfied.33

Therefore, the availability of a deduction or loss of the Year 2 DCL to offset an item of income or gain of FEX during the period that it was a foreign corporation for US tax purposes gives rise to a foreign use. As a result, USP cannot make a domestic use election with respect to the Year 2 DCL.34

Scenario 2

The de minimis exception states that no foreign use of a DCL will be considered to occur as a result of an item of deduction or loss composing such DCL being made available “solely” as a result of a de minimis reduction of the domestic owner’s interest in the separate unit.35 USP’s sale of the two percent interest in FEX to FC is a de minimis reduction of USP’s interest in the FEX Separate Unit, and the resulting foreign use of the Year 1 DCL is solely the result of that reduction. Consequently, the de minimis exception applies and no foreign use is considered to occur.
FC’s subsequent transfer of the two percent interest in FEX to FS does not change this result. Although the transfer also results in a foreign use of the Year 1 DCL as described in Treas. Reg. §1.1503(d)-3(a), this use occurred with respect to the same interest in the FEX Separate Unit the sale of which qualified for the de minimis exception (that is, the two percent interest sold by USP on January 1, year 3). As a result, this foreign use is also considered to arise solely as a result of the reduction in USP’s interest in the FEX Separate Unit.

Therefore, the de minimis exception applies and FC’s transfer of the FEX interest to FS does not result in a foreign use of the Year 1 DCL.

**Scenario 3**

The (c)(4) limitation can only prevent the application of the (c)(4) exception to what would otherwise be a foreign use. Neither the (c)(4) limitation nor the (c)(4) exception can cause a foreign use that does not otherwise occur. This is evident from the general structure of Treas. Reg. §1.1503(d)-3(a), which indicates that one should first apply the general definition of foreign use, and then determine whether any of the exceptions apply. The general definition of foreign use is preceded by the clause “Except as provided in paragraph (c) of this section,” which references exceptions to the general definition of foreign use, including the (c)(4) exception. The first sentence of the related provision of Treas. Reg. §1.1503(d)-3(c)(1) reinforces this principle by indicating that the (c)(4) exception constitutes an exception to the general definition of foreign use that only applies if there has otherwise been a foreign use.

Thus, prior to analyzing the application of the (c)(4) exception and the (c)(4) limitation it must be determined whether there would otherwise be a foreign use. In years 3 and 4 there is no foreign use of the DCL within the meaning of Treas. Reg. §1.1503(d)-3(a). This is the case without regard to the application of the (c)(4) exception. The (c)(4) exception generally applies where a foreign use would otherwise occur solely as a result of another person’s ownership of an interest in the partnership and the allocation or carry forward of an item of deduction or loss composing the DCL as a result of such ownership. Because USD is a domestic corporation, however, the allocation or carry forward of an item of deduction or loss composing the DCL does not result in a foreign use because the second condition of foreign use, described above, is not satisfied. That is, the item of income or gain that is referenced in the first condition of foreign use is not considered under U.S. tax principles to be an item of a foreign corporation, or an item of a direct or indirect owner of an interest in a hybrid entity that is not a separate unit; instead, such item is an item of a domestic corporation that is the direct owner of an interest in a hybrid entity that is a separate unit. For the same reason, the January 1, year 5, sale by USP of the interest in FEX to USD, a domestic corporation, does not result in a foreign use of the year 3 DCL within the meaning of Treas. Reg. §1.1503(d)-3(a).
Because there is no foreign use of the year 1 DCL within the meaning of Treas. Reg. §1.1503(d)-3(a), USP’s sale of the FEX interest does not implicate the (c)(4) exception or the (c)(4) limitation. This is the case even though the amount of the separate unit that is sold is in excess of the de minimis amount of the separate unit permitted to be reduced in a given year under the (c)(4) limitation.\textsuperscript{38}

Therefore, the last sentence of Treas. Reg. §1.1503(d)-3(c)(4)(iii) does not cause the January 1, year 5, sale of the FEX interest to result in a foreign use.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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

\textsuperscript{1} The IRS and Treasury Department issued regulations under section 1503(d) in March 2007 (“2007 regulations”). T.D. 9315. 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 which generally apply to DCLs incurred in taxable years beginning before the 2007 regulations apply. T.D. 8434.

\textsuperscript{2} The exception provided in Treas. Reg. §1.1503(d)-6(f)(3) prevents the deemed transfers resulting from the sale (see Rev. Rul. 99-5, 1999-1 C.B. 434) from constituting triggering events under Treas. Reg. §1.1503(d)-6(e)(1)(iv) or (v).

\textsuperscript{3} USD’s interest in FEX and its indirect interest in the Country X business operation carried on by FEX would also constitute a combined separate unit. However, this memorandum does not address the treatment of any dual consolidated loss attributable to such separate unit.

\textsuperscript{4} Treas. Reg. §1.1503(d)-2 and -4(b).

\textsuperscript{5} Treas. Reg. §1.1503(d)-2.

\textsuperscript{6} 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.

\textsuperscript{7} Treas. Reg. §1.1503(d)-5(e).

\textsuperscript{8} Id.

\textsuperscript{9} Treas. Reg. §1.1503(d)-1(b)(2)(i). The definition of a dual resident corporation also includes certain foreign insurance companies that make an election to be treated as a domestic corporation pursuant to section 953(d). Treas. Reg. §1.1503(d)-1(b)(2)(ii).

\textsuperscript{10} Treas. Reg. §1.1503(d)-1(b)(4)(i).

\textsuperscript{11} Treas. Reg. §1.1503(d)-1(b)(4)(ii).
Treas. Reg. §1.1503(d)-1(b)(9).

Treas. Reg. §1.1503(d)-1(b)(1). For purposes of this memorandum, references to domestic corporations have the meaning provided in Treas. Reg. §1.1503(d)-1(b)(1).

Treas. Reg. §1.1503(d)-1(b)(3).

Treas. Reg. §1.1503(d)-6(d).


Treas. Reg. §1.1503(d)-6(g). A certification under Treas. Reg. §1.1503(d)-6(g) is not required, however, for the year in which the DCL is incurred.

Treas. Reg. §1.1503(d)-1(b)(20).

Treas. Reg. §1.1503(d)-6(h).

Treas. Reg. §1.1503(d)-6(d)(2).

Treas. Reg. §1.1503(d)-6(d)(1)(v) and (d)(2).

Treas. Reg. §1.1503(d)-3(a)(1).

Id. See also Treas. Reg. §1.1503(d)-3(a)(2) for the definition of an indirect foreign use.

Treas. Reg. §1.1503(d)-3(b).

In addition, Treas. Reg. §1.1503(d)-3(c)(9) states that the Commissioner may provide, by guidance published in the Internal Revenue Bulletin, that certain events or transactions do or do not result in a foreign use. As of the date of this memorandum, no exceptions to foreign use have been provided under this provision.

Treas. Reg. §1.1503(d)-3(c)(5)(i).

Treas. Reg. §1.1503(d)-3(c)(5)(ii).

Treas. Reg. §1.1503(d)-3(c)(4)(i).

Id.

Treas. Reg. §1.1503(d)-3(c)(5)(iii).

Treas. Reg. §1.1503(d)-3(a)(1). This is the case regardless of whether any portion of the losses or deductions actually offsets or reduces any items of income or deduction under Country X laws, and regardless of whether items that may be offset or reduced are regarded as income under U.S. tax principles. Treas. Reg. §1.1503(d)-3(b).

Treas. Reg. § 1.1503(d)-3(a)(1).
The second condition is satisfied regardless of USP’s obligation under Treas. Reg. §1.367(b)-3(b)(3) to include in income as a dividend the all earnings and profits amount, if any, as a result of the deemed liquidation of FEX. See Conference Report to the Tax Reform Act of 1986, H.R. Conf. Rep. No. 99-841 ("The agreement’s provision applies to dual resident companies whether or not any of the income of any foreign corporation that the dual resident corporation’s loss may reduce in the foreign country is or will be subject to U.S. tax.").

In addition, such an all earnings and profits inclusion would not be included on the books and records of FEX and therefore would not reduce or eliminate the dual consolidated loss attributable to the FEX Separate Unit. See Treas. Reg. §1.1503(d)-5(c)(3).

Treas. Reg. §1.1503(d)-6(d)(1)(v). Even if FEX elected to be disregarded as an entity separate from its owner effective as of January 1, year 2, rather than July 1, year 2, and a DCL were attributable to the FEX separate unit for year 2, there may still be a foreign use of the DCL. In such a case, the foreign use may occur as a result of differences in the tax treatment of items under Country X and U.S. tax laws. For example, a depreciation deduction that is included in the computation of the year 2 DCL may be recognized for Country X tax purposes in year 1, a year in which FEX is classified as a foreign corporation for U.S. tax purposes. In addition, a foreign use would occur if Country X laws permitted FEX to carry back any portion of the DCL to a year in which FEX was treated as a foreign corporation under U.S. tax principles, unless such carry back was pursuant to an election and no such election was made. Treas. Reg. §1.1503(d)-3(c)(2).

See Treas. Reg. §1.1503(d)-3(c)(5)(i).

This foreign use is with respect to FS holding the FEX interest, whereas the foreign use resulting from the sale of the FEX interest is with respect to FC holding such interest.

See Treas. Reg. §1.1503(d)-7(c), Example 13, where the partner in the partnership is a foreign, rather than a domestic, corporation. In Example 13, there would be a foreign use but for the application of the (c)(4) exception.

If, however, USP had sold its entire 50 percent interest in FEX, then the sale would have constituted a triggering event described in Treas. Reg. §1.1503(d)-6(e)(1)(iv) and (v).