November 14, 2006

Hon. Mark. W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Proposed Regulations Relating to Dual Consolidated Losses (Prop. Reg. §§1.1503(d)-1-1.1503(d)-6)

Dear Commissioner Everson:

Enclosed are comments concerning Proposed Regulations Relating to Dual Consolidated Losses (Prop. Reg. §§1.1503(d)-1-1.1503(d)-6). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department
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Harry (Hal) J. Hicks, III, International Tax Counsel, Treasury Department
Steven A. Musher, Associate Chief Counsel (International), Internal Revenue Service
John Merrick, Special Counsel, Office of the Associate Chief Counsel (International), Internal Revenue Service
Benedetta Kissel, Deputy Associate Chief Counsel (International), Internal Revenue Service
These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by F. Scott Farmer of the Committee on Foreign Activities of U.S. Taxpayers (“FAUST”). Substantive contributions were made by Peter Blessing, Paul Crispino, Robert Katcher, Jim Lynch and Al Paul. The comments were reviewed by C. Ellen McNeil of the Committee on Government Submissions and Stephen E. Shay as Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these comments and/or other members of the Section of Taxation have clients who might be affected by the U.S. federal income tax principles addressed by these comments, except as noted below, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments. Two members who were so engaged with respect to the portion of the regulations relating to stock basis adjustments did not participate in the preparation of the portion of these comments addressing that topic.

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Date: November 14, 2006
EXECUTIVE SUMMARY

These comments address proposed amendments (“Proposed Regulations”) to the rules for limiting allowance of deductions for dual consolidated losses under section 1503(d) of the Internal Revenue Code of 1986, as amended (the "Code"). The comments are in response to the solicitation for comments in a notice of proposed rulemaking published on May 19, 2005 in the Federal Register.

The Proposed Regulations would revise the existing Treasury Regulations under section 1503(d), which provides that, in general, the use of a dual consolidated loss ("DCL") of a dual resident corporation (or a separate unit of a domestic corporation) cannot reduce the taxable income of any other member of the corporation’s affiliated group. The preamble to the Proposed Regulations indicates that the revisions have been designed to minimize cases of potential over- and under-application of the DCL rules, to modernize the existing regulations to take into account the entity classification regulations and to reduce, to the extent possible, the administrative burden imposed by the rules on taxpayers and the Commissioner. We believe the Proposed Regulations would accomplish these goals in many respects and commend Treasury and the Internal Revenue Service for the thought and care that were brought to bear at various levels in this exercise.

We nevertheless believe certain modifications are worthy of consideration.

Our principal recommendations may be summarized as follows:

1. The proposed same country combination rule should be expanded to include dual resident corporations ("DRCs") as well as all same-country separate units and should be applied on a consolidated group basis. If the final regulations do not narrow the “all or nothing” rule for recapture on triggering events of combined groups, taxpayers should be allowed to elect to consolidate on a country-by-country basis, and to choose which same-country separate units or DRCs to consolidate.

2. The definition of a foreign branch separate unit should not include a branch that would not be subject to income tax in a foreign jurisdiction such that there would be no potential use of a branch loss for foreign tax purposes (whether because of exemption based on a treaty permanent establishment limitations or because of the passive nature of the activities).\(^1\)

\(^1\) It also should be clarified that home-country activities of a DRC or hybrid entity separate units can qualify as a foreign branch.
3. The cross-reference for purposes of determining foreign branch status should be limited to Treasury Regulations §1.367(a)-6T(g)(1), which should be applied separately to each domestic corporation, hybrid entity, grantor trust and partnership. All home country integral business activities of each such entity should be aggregated and treated as a single foreign branch, whether combined under foreign law or not (prior to applying the same-country combination rules described above).

4. We believe that difficult issues of mixed U.S. and foreign law should be deferred until relevant, and therefore that the requirement that taxpayers attach to their original return (including extensions) documentary evidence to support no possibility of foreign use should be deleted as unnecessarily burdensome and costly. Thus, even if a taxpayer filed a domestic use election, it should not be barred from correcting errors in the calculation of a DCL or from arguing at the time of a triggering event that no use under foreign law was possible, without advance approval by the District Director for Field Operations.

5. The special basis rules should be eliminated to provide a more consistent, and thus fairer, operation of the rule that capital losses not be subject to section 1503(d) limitation.

6. The “mirror rule” should not apply to DRCs or separate units where no foreign affiliates exist that could potentially be denied the use of the loss under the mirror legislation of the foreign country. In addition, we believe that the mirror rule should be suspended even where a DRC or separate unit has affiliates, until more progress is made to address these problems through bilateral agreements.

7. U.S. corporations that operate direct foreign branch separate units (or through a non-hybrid partnership or grantor trust) should be allowed to use the method under the income tax treaty, if any, between the United States and the foreign country for determining the net income or loss of a foreign branch, provided the U.S. corporation applies that method for foreign income tax purposes. The same treaty method should be allowed for foreign branch operations conducted by a hybrid entity outside its home country (either directly or indirectly through a non-hybrid partnership or grantor trust), if both the hybrid entity’s foreign country and the branch’s foreign country also has a treaty with the United States and the U.S. corporation otherwise elects to use the treaty method. Finally, if the U.S. corporation has entered into an advance pricing agreement (“APA”) with the foreign country concerning the taxation of the foreign branch, then the APA method should apply even if the APA was entered into prior to the effective date of the final regulations.

8. We believe that a more appropriate time for monitoring foreign use under the domestic use election regime would be 5 years rather than 7 years.
9. The “all or nothing principle” at least should be modified to exclude permanent differences, resulting from differences between U.S. and foreign tax law, in computing recapture amounts if the taxpayer provides documentation supporting the permanent difference. We further recommend that the contemplated revenue procedure list permanent items that must be taken into account.

10. An exception should be provided in the final regulations that would allow the IRS to enter into a closing agreement to avoid recapture in appropriate circumstances. For example, it would be useful to have a closing agreement exception to address transfers to foreign persons where adequate safeguards exists to assure that a recapture tax would be collected (such as if the foreign person has U.S. subsidiaries which are willing to agree to serve as agents for assessment of tax against the foreign person) and where there exist assurances that future treatment of any carryover attributes could be monitored.

11. Section 986(c) gain or loss should be treated similarly to subpart F income and section 78 gross-ups, by providing that section 986(c) gain or loss on a distribution, or deemed distribution, will be treated as income or loss in accordance with the way in which the distribution, or deemed distribution, is treated for section 1503(d) purposes.

12. The requirement to limit the use of SRLY losses to only years in which the consolidated group has sufficient income to offset the losses is not appropriate in the DCL context. The recapture amount should be reduced by the income generated by the separate unit or DRC in such subsequent or prior taxable year whether or not the consolidated group has sufficient taxable income in that year.

13. We recommend that taxpayers be allowed to elect to apply the reduction in the monitoring period, from 15 to either 7 or 5, as we have requested, retroactively. Taxpayers should be allowed to elect to replace their existing (g)(2) agreements covering the DCL amounts as determined under the old regulations with a new domestic use agreement, provided that the taxpayer is otherwise able to file the agreement, including the ability to certify that no foreign use under the new regulations has occurred in any year since the original (g)(2) agreement was filed. In the case of (g)(2) agreements covering DCLs that have been subject to a closing agreement(s), we recommend that all parties that are jointly and severally liable consent to the filing of new agreements and that new agreements be filed by all such parties. We also recommend that the election to replace be subject to a consistency rule that would require that all (g)(2) agreements must be replaced, with an exception for (g)(2) agreements.

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2 Examples of permanent differences are items that are deductible or subject to capitalization for U.S. tax purposes that are not so treated for foreign law purposes.
agreements covering DCLs for which a prior closing agreement is involved, since multiple parties must consent to replace.

14. We also recommend that taxpayers be allowed to elect to apply the regulations retroactively for all open years to DCLs for which no (g)(2) agreement is outstanding, subject to consistency requirements. Consideration should be given to making certain of the changes that have been acknowledged as “clarifications” in the preamble to the Proposed Regulations effective retroactively whether or not the taxpayer elects to apply the new regulations.

COMMENTS

I. INTRODUCTION

A. Background

These comments address proposed amendments to the rules for limiting allowance of deductions for dual consolidated losses under section 1503(d) of the Internal Revenue Code of 1986, as amended (the "Code"). The dual consolidated loss rules of section 1503(d) were first adopted in the Tax Reform Act of 1986 to address a perceived abuse, the ability to cause a corporation to be considered resident in two countries so that a single loss could be deducted against two streams of income. This is sometimes referred to as “double dipping.”

The basic approach of the statute is to deny the use of a “dual consolidated loss” against the income of any other member of the corporation’s U.S. affiliated group. A “dual consolidated loss” ("DCL") means any net operating loss of a domestic corporation where the domestic corporation is subject to an income tax of a foreign country on a worldwide or residence basis. To the extent provided in regulations, a DCL does not include any loss that under the foreign income tax law does not offset the income of any foreign corporation.

In 1988, section 1503(d) was amended to provide that, to the extent provided in regulations, similar loss disallowance rules would apply to any loss of a “separate unit” of a domestic corporation as if the separate unit were a domestic corporation. As has been observed by others, the practical scope of the DCL rules expanded with the adoption of the “check-the-box” entity classification rules and, in particular, recognition that a

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4 I.R.C. §1503(d)(1).
7 I.R.C. §1503(d)(3).
limited liability foreign legal entity could elect to be disregarded for U.S. federal income tax purposes.\(^8\)

The DCL statute left much to regulations with little other than the broadest guidance as to the policy objectives underlying the statute. Generally, the articulated policy was that a foreign-owned dual consolidated corporation should not be permitted to have a competitive advantage over a U.S. company in financing the acquisition or operation of a U.S. business.\(^9\) The DCL rule also was applied to U.S.-owned foreign corporations with less articulation of the objective other than that the Committee was not aware of good reasons for double dipping.\(^10\) One policy rationale could be that such double dipping may favor foreign over U.S. investment, but this was not articulated and it would be hard to reconcile this rationale with other Code rules such as those that address deferral.

With little guidance, the IRS and Treasury have borne the responsibility for infusing regulations with policy content. In addition, the regulations have had to provide guidance regarding the application of rules to a separate unit, for which there is relatively little precedent in the U.S. (and non-U.S.) tax law. Current and prior regulations have taken a number of steps to constrain the breadth of the possible loss disallowance, including, \textit{inter alia}, allowing a U.S. corporation to use a DCL to offset income of a U.S. affiliate if it makes an election not to use such losses to reduce income of a foreign person.\(^11\) The Proposed Regulations have as one of their principal objectives further adjustments to the scope of the application of the DCL rules in light of experience and changes in law since the regulations were last revised.

The Tax Section commends the drafters of the Proposed Regulations for a thoughtful and comprehensive attempt to rationalize, update, and simplify the DCL regulations. In many respects, we believe that the Proposed Regulations have accomplished the goals set forth in the preamble.\(^12\) Despite these good faith efforts, the Proposed Regulations remain excessively broad and unclear in certain respects.

The Proposed Regulations would continue to impose loss restriction in the United States in circumstances where no actual double dip of all or a significant portion of the losses against foreign income occurs. In large part, this consequence is a result of the approach of the Proposed Regulations that all potential double dip situations are to be covered by the regulation, regardless of the nature of the operations at issue and regardless of whether such use occurs directly or indirectly. A more fine-tuned approach,

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\(^12\) 70 Fed. 29869 (2005).
such as determining whether a specific loss in fact reduces foreign income, has been rejected as too difficult to administer. Although a contemplated revenue procedure providing safe harbors from so-called DCL recapture "triggering events" should reduce the circumstances in which recapture of a DCL subject to a domestic use election would be required, we believe that additional modifications to the substantive rules are necessary.

Our comments below focus on major areas of concern and respond to the various specific comments you have requested. We also address a series of other more technical issues as well as effective date issues. Before turning to specific comments, however, we suggest that it is time to reconsider the purpose and scope of the DCL rules.

B. Balancing DCL Rule Benefits and Burdens

The simultaneous over-breadth and under-reach of the DCL rules have been commented on by others. Clearly, dual resident corporations are only one potential mechanism to achieve inconsistent tax results between two tax systems and thereby achieve a taxpayer-favorable "tax arbitrage." It surely is not feasible, however, for the U.S. tax system to address all forms of tax arbitrage. Indeed, the competitiveness rationale that underlies the DCL rules can not be taken so far as to require that all tax differentials between U.S. and foreign owned taxpayers owning U.S. businesses must be eliminated and/or that the effective tax on foreign income of U.S. taxpayers must be equalized with the tax on domestic income.\textsuperscript{13} We respectfully suggest that the DCL rules should be understood as an anti-abuse regime, not as a rule of income tax accounting. Indeed, the origins of the DCL rules lie in structured financing arrangements principally designed to obtain a double dip benefit, not to carry on an operating business that carries normal operating risk of income or loss.

As applied in DCL regulations to date, however, the DCL rules may be tripped in the most mundane and everyday business operations. Their scope and complexity impose administrative burden and cost that is not justified by their contribution to the U.S. fisc. Indeed, our experience is that losses are almost always taken against U.S. income notwithstanding the DCL regime. Although the so-called “mirror rule” of the regulations, which denies U.S. use altogether in the face of a foreign law denying use in the foreign jurisdiction of a DCL, precludes U.S. use of such a loss, this rule effectively results in denial of a deduction in any country for a real economic expense.

We believe that the DCL rules should be adjusted to apply in a manner consistent with their anti-abuse origins. What is called for is a balance between the need to combat double-dipping using structures that are not customarily used to further the taxpayer’s trade or business while allowing branch operations not primarily designed to achieve a

\textsuperscript{13} For a thoughtful articulation of the policy issues that the DCL regulations raise, see H. David Rosenbloom, The David R. Tillinghast Lecture: \textit{International Tax Arbitrage and the \textquotedblleft International Tax System\textquotedblright}, 53 Tax Law Review No. 2, 137 (2000). We note that despite the extensive discussion of the statute and history of the prior Proposed Regulations in the preamble of the regulations, these policy considerations are not addressed.
Our comments are intended to move the regulations toward such a balance.

II. COMMENTS ON PROPOSED REGULATIONS

A. Separate Unit/DRC Definitions

We believe that a number of changes are necessary to clarify, simplify, and bring the definitions of a separate unit and a dual resident company (“DRC”) more in line with the purposes of section 1503(d).

1. Modify Same Country Separate Unit Combination Rule.

The current regulations allow foreign branch separate units to be combined in limited circumstances. The units must be owned by the same domestic corporation and the losses of each must be available to offset the income of the other under the laws of the foreign country. Proposed Regulation §1.1503(d)-1(b)(4)(ii) would expand the same country separate unit combination rule of the current regulations to allow all separate units, including interests in a hybrid entity separate unit, in the same country to be combined provided they are owned by a single domestic corporation and provided the losses of each separate unit are made available to offset the income of the other separate units under the income tax laws of a single foreign country. The Proposed Regulations, however, would not apply the rule on a consolidated basis or to DRCs.

We believe that the proposed same country combination rule has much to commend. First, we believe that expanding the same country combination rule to include all forms of separate units is laudable. The net effect would be to appropriately narrow losses subject to the DCL regime, as combined operations would be less likely to produce a net operating loss. We note, however, that expanding the same country rule puts more pressure on the “all or nothing principle,” because it increases the likelihood that taxpayers would be unable to demonstrate no possible foreign use, for example, when less than all of the separate units in the combined group were sold. To some extent, this concern is tempered by the fact that the proposed combination rule would be elective in effect. For example, if a taxpayer owns distinct operations in a country, it could either structure these operations so that they are owned by a single domestic corporation and achieve combination, or it could structure into separate domestic corporation ownership and achieve more flexibility in avoiding potential recapture on the disposition of one of the operations.

As just discussed, there is an interaction between the scope of the separate unit combination rule and the “all or nothing principle” applied to DCL recapture upon a triggering event. In our view, the better result from a policy perspective would be to expand the same country combination rule further and provide for appropriate exceptions to the “all or nothing principle” upon a triggering event. As discussed below, however, the only alternative identified in the preamble to the Proposed Regulations to reduce the

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The scope of the “all or nothing principle” is to adopt a pro rata recapture rule in the case of recapture triggered by a disposition of a separate unit that is part of a larger combined group.

The preamble to the Proposed Regulations asked for comments on whether a pro rata rule could address the heightened all or nothing concerns in cases where there is a disposition of a separate unit. The contemplated pro rata rule appears to be one that would be based on revenue or other more general criteria. As a general matter, we do not favor such a rule: it would divorce recapture from any reasonable approximation of what a factual determination would provide. Furthermore, we believe that allowing taxpayers to both elect into combination and to apply a pro rata rule would provide opportunities for manipulation.

If a pro rata recapture rule were adopted, we would recommend that the same country combination rule be expanded to apply to all operations and all members of the consolidated group, as we recommend below, so that the rule is not elective. Even in these circumstances, however, we believe such a rule would produce results that are arguably not acceptable given that it would not be based on what losses actually carryover under foreign law or even an approximation of what might carryover unless it were refined in a more precise manner. For example, assume a U.S. consolidated group (X) is engaged in a business in Country A as well as other countries and acquires another U.S. consolidated group (Y) that also has a Country A business. Assume after the acquisition, the new Y Country A business generates profits but the combined Country A group generates a significant loss for which a domestic use election is made. Either because of regulatory restrictions (e.g., SEC) or because these assets represent unwanted assets, the next year X sells the Y Country A business to a foreign corporation causing a triggering event and recapture of the prior year combined DCL. Assume further that, even though the newly acquired business was profitable, X could not demonstrate, due to timing differences, that no portion of expenses, deductions, or losses that made up the combined DCL, which took into account the expenses and deductions of the new business, would carryover for Country A purposes on the sale of the Country A business. Particularly in these circumstances, which in our experience occurs frequently, we do not believe that taxpayers would desire a rule that would require that a pro rata portion of the DCL be recaptured.

Accordingly, unless the final regulations refine the pro rata rule in a manner that would reach more appropriate results or provide other appropriate means to address triggering events related to combined groups, we believe that some sort of elective regime should be retained. Our recommendations for expanding the same country combination rules are set forth below. We then address what type of election we believe should be considered if the final regulations do not adopt an appropriate means of addressing the all or nothing principle as applied to combined groups.

We recommend two changes that would expand the scope of the combination rule. First, we recommend that the proposed same country combination rule be expanded

to include DRCs as well as all same country separate units. Under the Proposed Regulations, a U.S. corporation that owns two DEs in a single foreign country that does not allow their income and losses to be combined, such as Canada, would not be permitted to combine those operations in determining whether a DCL exists. Yet if one of the DEs were to generate a DCL, the taxpayer could eliminate the DCL by merging the entities and using the losses to offset the income of the profitable DE under foreign law, as this would not be a prohibited foreign use.\(^{16}\) The final rule should not require taxpayers to go through the process of filing a domestic use election and then later merging or otherwise combining under foreign law simply to achieve the same result that would have been obtained had they combined the operations in the first place. Even if such combination is difficult to achieve, it is unnecessarily burdensome to require that taxpayers report the loss as a DCL based on the proposition that a carryover of some portion of the DCL is possible under foreign law and then to deny combination on the proposition that taxpayers may in fact not be able to achieve such a carryover.

More significantly, the purpose of the DCL rules is to restrict a single loss against two separate streams of income -- one subject to tax in the United States but not subject to tax currently in the foreign country, and one subject to tax in the foreign country but not subject to tax currently in the United States.\(^{17}\) Given this purpose, the final regulations should not be concerned with a potential foreign use of a loss where in the same country the taxpayer itself has generated an equal amount of income that is also subject to tax in the United States. The DCL rules acknowledge for this reason that the loss can be used against this income under foreign law and not cause a triggering event.

Finally, in our experience with the similar standard under the current regulations, whether the income and losses of separate units are made available for foreign use would raise technical issues as to whether the separate units satisfy this standard in certain cases even if consolidation under foreign law is generally allowed.\(^{18}\) Accordingly, we believe expanding the same country combination rule to cover all income or loss of separate units or DRCs in a single country is an appropriate rule and should be reflected in the final regulations.\(^{19}\)


\(^{18}\) For example, if the foreign country denies certain deductions that are included in the computation of the DCL for U.S. purposes, would the standard be satisfied? As another example, what if combination is allowed under foreign law for federal income tax purposes but not for local income tax purposes?

\(^{19}\) Treasury Regulation §1.1503-2(c)(3)(iii) of the current regulations imposes a similar limitation to combined same country separate unit treatment; Treasury Regulation §1.1503-2(c)(15)(ii) also permits losses of one separate unit to be used to offset the income of another separate unit in the same country without causing a triggering event. Nothing explains why the drafters of the current regulations limited combination for DCL purposes to situations only in which separate units could combine under foreign law. Obviously, where operations can be combined under foreign law, it is easier to understand why these operations should be allowed to combined for determining whether a DCL exists. It may be that the drafters simply did not consider the issue beyond these more obvious
We also recommend that the same country combination rule, as modified by our first recommendation, be applied on a consolidated group basis. The preamble to the Proposed Regulations explains that separate units owned by members of the same consolidated group apparently were not included due to concerns with the authority to cover these situations:

The combination rule in the proposed regulations does not combine separate units owned by different domestic corporations, even if the domestic corporations are included in the same consolidated group. The IRS and Treasury believe this approach is consistent with section 1503(d)(3), which provides that, to the extent provided in regulations, a loss of a separate unit of a domestic corporation is subject to the dual consolidated loss rules as if it were a wholly owned subsidiary of such domestic corporation.\textsuperscript{20}

The preamble requests comments on whether there is authority to expand the combination rule to DRCs as well as to separate units owned by the same consolidated group.\textsuperscript{21} We believe that Treasury/IRS have ample authority to expand the Proposed Regulation rule to all members of a consolidated group as well as to DRCs.

The current regulations arguably already allow a modified form of consolidated treatment for foreign branch status. Treasury Regulations §1.1503-2(b)(3)(i)(A) defines foreign branch, as would the Proposed Regulations, by cross-reference to §1.367(a)-6T(g).\textsuperscript{22} Treasury Regulations §1.367(a)-6T(g)(3) provides that the activities of separate members of a consolidated group are combined in determining foreign branch status. Additionally, as §1.367(a)-6T(g)(3) itself highlights, Treasury/IRS have already addressed a similar issue in the related context of foreign branch recapture, as section 367(a)(3)(C) defines a foreign branch as a foreign branch “of a United States person.”

Moreover, Treasury/IRS have broad authority to issue interpretive regulations under section 1503(d). Section 1503(d)(3) provides “[t]o the extent provided in regulations” the limitations on loss utilization for a domestic corporation apply to a separate unit “in the same manner as if such unit were a wholly owned subsidiary of such corporation.” Because certain foreign countries allow branches to consolidate with related corporations and do not tax these branches on a worldwide resident basis, the Proposed Regulations would define separate units without regard to the taxing fact patterns or it may be that this was considered a rule of convenience, since the taxpayer would have already combined the computations under foreign law. Additionally, at the time the drafters finalized the current regulations, the complexity of monitoring losses due to the check-the-box regulations did not exist and thus the additional burden imposed on taxpayers to file separately for these operations may not have been viewed by the drafters as overly burdensome. In any event, whatever the justification, for the reasons discussed in the text above, we believe that all same country operations should be combined.

\textsuperscript{21} Id.
\textsuperscript{22} See discussion in text at II. A. 2., directly below.
jurisdictional requirement applicable to domestic companies.23 Additionally, although section 1503(d)(1) prohibits the use of a loss against the income of “any other member of the affiliated group,” and a member is defined in section 1502(b) to exclude certain domestic corporations, the Proposed Regulations would define domestic member of an affiliated group without regard to these exceptions for domestic companies.24 These and other interpretations of the definitions of a DRC and a separate unit reflected in the Proposed Regulations must be based on policy considerations that are sanctioned either by section 1503(d)(3) or by the general regulatory authority granted to the Secretary by section 7805.

Our recommended changes to the definition of a separate unit and a DRC are also supported by strong policy considerations. As expressed in the legislative history, and as discussed above, the purpose of the DCL rules is to restrict a single loss against two separate streams of income -- one subject to tax in the United States but not subject to tax currently in the foreign country, and one subject to tax in the foreign country but not subject to tax currently in the United States.25 The abuse that the rules are concerned with, therefore, should be considered to arise only where there is a potential use of the net deductions against a separate stream of income under foreign law not subject to current tax in the United States. Thus, where a consolidated group has generated both income and loss in a single country, we believe that the regulations should permit these results to be combined for DCL purposes.

Finally, in the consolidated return context, Treasury/IRS have broad authority under section 1502 to provide rules to treat members of a consolidated group as a single taxpayer, as the regulations under section 367(a)(3)(C) demonstrate. Although section 1503(d) is a special rule for purposes of the computation of tax for consolidated groups, we do not believe this limits the general authority granted to Treasury/IRS in section 1502 to apply single taxpayer concepts to reach results that are consistent with Congressional intent in section 1503(d).26

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25 See note 17, supra.
26 As a result of our recommendation, a number of collateral changes would be necessary to the operating rules. A potentially significant collateral issue is how the SRLY limitations under Proposed Regulations §1.1503(d)-3(c) would apply. We recommend that the SRLY limitations be applied to the combined DRC/separate unit group as a whole, regardless of whether the separate units or DRCs are owned by different members of the consolidated group, by taking into account only income, gain, deductions and loss of each separate unit or DRC within the group and then allowing the DCL to be absorbed by the net income of the group. Upon a subsequent transfer, the concepts in Proposed Regulations §1.1503(d)-2(c) could then be modified to apply in a similar manner to the expanded group. Another collateral issue involves the impact of our recommendations on the successor rules, set forth in Proposed Regulations §1.1503-2(c)(2). If our recommendation is accepted, the special rules for section 381 transactions should be modified to allow losses after a section 381 event to offset income of separate units and DRCs owned by the successor or members of the successor’s consolidated group in the same foreign country if after the transfer such separate unit
As discussed above, if the final regulations do not provide appropriate rules to address recapture on triggering events of combined groups, we believe that taxpayers should be allowed flexibility in determining combined groups. Because we believe that Treasury/IRS have the authority to apply the definition of a separate unit and a DRC on a consolidated basis, it should also raise no authority issue to allow taxpayers to elect how the consolidation rules would apply. We recommend that the taxpayers be allowed to elect to apply the same country combination rules on a consolidated, country-by-country basis. Furthermore, taxpayers should be allowed to choose which same country separate units or DRCs to consolidate. The taxpayer would be bound by its election but would be allowed to elect whether or not to include new separate units or DRCs in the combined group even if these new separate units or DRCs were consolidated by another consolidated group or domestic taxpayer the stock of which is acquired by the taxpayer.

2. **Refine Definition of Foreign Branch Separate Unit.**

We recommend the definition of a foreign branch separate unit in Proposed Regulation §1.1503(d)-1(a)(4)(i)(A) be refined to bring it more in line with the policy of section 1503(d) and to simplify and clarify the application of the rules. In particular, we recommend that the definition of a foreign branch separate unit not include a branch that would not be subject to tax in a foreign jurisdiction.27

The Proposed Regulations would define a foreign branch separate unit by cross-reference to Treasury Regulation §1.367-6T(g).28 A foreign branch is defined in Treasury Regulation §1.367(a)-6T(g)(1) for purposes of section 367(a)(3)(C) as follows:

For purposes of this section, the term “foreign branch” means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person performed outside the United States constitute a foreign branch operation must be determined from all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States. Whether activities outside the United States constitute a foreign branch operation must be determined under all the facts and circumstance. Activities outside the U.S. shall be deemed to constitute a foreign branch for purposes of this section if the activities constitute a permanent establishment under the terms of a treaty between the U.S. and the country in which the activities are carried out.

The policy of section 367(a)(3)(C) is directed at recapturing foreign branch losses that were deducted for U.S. tax purposes when the incorporation of the foreign business

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27 A hybrid entity separate unit is defined as an entity not taxable as an association for U.S. purposes that is subject to entity level income tax in a foreign country. Prop. Reg. §§1.1503(d)-1(b)(3) and (b)(4)(i)(B).

could lead to deferral of tax on the income of a foreign corporation.\textsuperscript{29} Normally, the transfer of assets to a foreign corporation for use in an active conduct of a foreign trade or business is an exception to section 367(a)(1) gain recognition.\textsuperscript{30} Section 367(a)(3)(C) overrides this active trade or business exception where the foreign business being transferred has generated prior losses, requiring gain to be recognized to the extent of such prior losses.

Given the different purpose for the definition of a foreign branch separate unit under section 1503(d), we recommend that the definition of a foreign branch separate unit by cross-reference to Treasury Regulations §1.367(a)-6T(g)(1) be modified to make clear that business activities that are not subject to income tax in a foreign country would not be classified as a foreign branch. In our view, the definition of a foreign branch separate unit in the DCL context should be directed to cases where there is potential use of a branch loss for foreign tax purposes. Thus, for example, if a U.S. company engages in construction activities in a foreign country that are exempt from taxation under the permanent establishment clause of the income tax treaty between the U.S. and the foreign country due to their limited duration, this would presumably constitute a foreign branch for section 367(a)(3)(C) recapture purposes under §1.367(a)-6T(g)(1). Given that the construction activities are not subject to foreign income tax in the country, it does not seem appropriate that any losses generated in such operations would be subject to section 1503(d) limitation.

A foreign branch should no more be deemed to arise in such a case than in the case where a U.S. company engages in passive activities overseas. For example, if a U.S. company were to establish a foreign office that borrows to fund the acquisition of a foreign subsidiary, similar to the financing operations that led to the enactment of section 1503(d) in 1986, arguably these operations would not constitute an “integral business operation” under Treasury Regulations §1.367(a)-6T(g)(1).\textsuperscript{31} Investment assets are normally subject to current taxation under section 367(a) and special rules apply to stock.\textsuperscript{32} Additionally, in other places the section 367(a) regulations expressly exclude isolated investment activities from the definition of trade or business activities.\textsuperscript{33} Such limited activities, however, would normally not be expected to constitute a permanent establishment or otherwise cause the U.S. company to be subject to net basis taxation in a

\begin{itemize}
\item \textsuperscript{30} I.R.C. §367(a)(3); Treas. Reg. §1.367(a)-2T.
\item \textsuperscript{31} Example 7 of the Proposed Regulations appears to reach the same conclusion. In Example 7, P owns DEx. DEx incurs an interest expense and its only asset is an interest in a partnership for which a check-the-box election has been made to treat the partnership as a corporation for U.S. tax purposes. Example 7 concludes that the interest expense is a dual consolidated loss attributable to “P’s interest in DEx.” See also, Example 29. (But see discussion in text below, regarding the classification of Hybrid Entity Separate Unit or DRC same country activities as foreign branches.)
\item \textsuperscript{32} Treas. Reg. §1.367(a)-3.
\item \textsuperscript{33} Treas. Reg. §1.367(a)-2T(b)(2)(ii).
\end{itemize}
foreign country; thus, it seems appropriate that these activities would not constitute a foreign branch for section 1503(d) purposes.

Accordingly, we recommend that the general definition of a foreign branch under Treasury Regulations §1.367(a)-6T(g)(1) be modified to make clear that business activities that are not subject to income tax in the foreign country would not be classified as a foreign branch for section 1503(d) purposes.

We also recommend that the interaction between the foreign branch separate unit definition on the one hand and the DRC and hybrid entity separate unit (“HESU”) definitions on the other be clarified by expressly providing that home-country activities of a DRC or HESU can qualify as a foreign branch and by modifying the examples to be consistent with this conclusion. Where the operations of a DRC or HESU are conducted in a foreign country other than the country in which the DRC or HESU is subject to tax on a worldwide or resident basis, the Proposed Regulations would make clear that a DRC or the domestic owners of a HESU can have a foreign branch.34 If the operations of the DRC or HESU are conducted in its home taxing jurisdiction, however, the Proposed Regulations are not as clear how the separate unit foreign branch rules would apply. The confusion is caused by whether the cross-reference to “foreign” branch in Treasury Regulation §1.367(a)-6T(g)(1) is intended to refer to activities of the DRC or HESU outside the United States, as the rules normally would be applied in the section 367(a)(3)(C) context, or only to activities of the DRC or HESU that are conducted outside the relevant taxing jurisdiction of such DRC or HESU.

The examples compound the confusion. Example 1 provides that DEx owns FBx, implying that DEx, a HESU, can have a foreign branch in its taxing jurisdiction (Country X). Yet Examples 35, 39, and 40, as well as other examples,35 appear to reach the opposite conclusion in situations where the facts would seem to compel a foreign branch determination.

In Example 35, P owns DEx. DEx, a Country X disregarded entity, has substantial business operations, including employees, sale operations, research and development activity, and loans. Example 35 provides that the amount of costs attributable to P’s “interest in DEx” is $50, taking into account all expenses and income generated by DEx. Proposed Regulations §1.1503(d)-5(b)(6) provides a general admonition that neither the assets nor operations of an entity illustrated in the examples is considered to constitute a foreign branch separate unit (and based on the facts in Example 35 the operations are not solely in the United States). Accordingly, a reasonable conclusion from Example 35 is that DEx’s business activities cannot be a foreign branch because they are conducted in the same country as that in which DEx is subject to tax.

34 Prop. Reg. §1.1503(d)-5, Examples 5, 7, 30, and 34.
35 The other examples that seem to factually raise this issue are Examples 6, 9, 12, 13, 14, 20, 23, 24, and 25.
Example 39 is even clearer. In Example 39, P owns DEx and DEx has sales income and depreciation deductions for Country X purposes, so there is no need to assume, as in Example 35, that DEx is operating a business in Country X. Yet Example 39 concludes that the sales income and depreciation deductions are “attributable to P’s interest in DEx”; thus, again, strongly implying that DEx’s business operations in its taxing jurisdiction cannot constitute a foreign branch in Country X.

Example 40 adds that DEx has interest expense for Country X purposes, in addition to the sales income and depreciation, but with no change in the implicit classification of the activities as not constituting a foreign branch.

To address the confusion, we recommend that the final regulations clarify whether home country activities of a DRC or HESU can qualify as a foreign branch. In the event our first recommendation to expand the combined separate unit rule is not adopted, we know of no reason that integral business activities conducted by a DRC or HESU in their home taxing jurisdiction, just as integral business activities of a domestic owner that are conducted in that country, should not give rise to a foreign branch.

Finally, the cross-reference to Treasury Regulation §1.367(a)-6T(g) in the Proposed Regulations apparently would also pick up the rules in -6T(g)(2) and (3). Treasury Regulation §1.367(a)-6T(g)(2) provides guidelines for when various foreign operations are to be treated as a single foreign branch, and §1.367(a)-6T(g)(3), as noted above, allows foreign branches of separate members of a consolidated group to be combined in determining foreign branch status. Treasury Regulations §§1.367(a)-6T(g)(2) and (3) provide, in relevant parts, as follows:

(2) More than one branch. * * * * Whether the foreign activities of a U.S. person are carried out through more than one branch must be determined under all of the facts and circumstances. In general, a separate branch exists if a particular group of activities is sufficiently integrated to constitute a single business that could be operated as an independent enterprise. For purposes of determining the combination of activities that constitute a branch operation as defined in this paragraph (g), the nominal relationship among those activities shall not be controlling. Factors suggesting that nominally separate business operations constitute a single foreign branch include a substantial identity of products, customers, operational facilities, operational processes, accounting and recordkeeping functions, management, employees, distribution channels, or sales and purchasing forces. . . .

(3) Consolidated group. For purposes of this section, the activities of each of two domestic corporations outside the United States will be considered to constitute a single foreign branch if—

(i) The two corporations are members of the same consolidated group of corporations; and

(ii) The activities of the two corporations in the aggregate would constitute a single foreign branch if conducted by a single corporation.

We believe that applying Treasury Regulations §§1.367(a)-6T(g)(2) and (3) to determine foreign branch status would create complexity that could be avoided with
certain modifications to -6T(g)(1). If the rules of -6T(g)(1) were applied separately to each domestic corporation, hybrid entity, grantor trust, and partnership, and all home country integral business activities of each such entity were treated as a single foreign branch, there would be no need to apply the difficult factual determinations required in -6T(g)(2) to determine whether one or more foreign branches exists, including applying the DCL computational rules to each such foreign branch, as the integral business activities of the entity would be combined in any event under our recommendation that the general combination rule encompass all income or loss of separate units or DRCs owned directly or indirectly by a domestic corporation whether or not they are combined under foreign law. Additionally, there would be no need to apply the combination rules in -6T(g)(3) to achieve single foreign branch treatment, as our recommended single country combination rules would address these situations.

Accordingly, we recommend that the cross-reference for purposes of determining foreign branch status be limited to Treasury Regulation §1.367(a)-6T(g)(1), that 6T(g)(1) be applied separately to each domestic corporation, hybrid entity, grantor trust and partnership, and that all home country integral business activities of each such entity be aggregated and treated as a single foreign branch whether combined under foreign law or not. After applying -6T(g)(1), our recommended same country combination rules would apply.

The following example illustrates our recommendations:

Example. P is a domestic corporation engaged in the financial services business in Country X through HEx. HEx established its headquarter office (“home office”) in the capital of Country X. The home office engages in a securities trading business. HEx also engages in other financial services activities in several other cities in Country X, including securities trading. The home office entered into borrowings that have been used to fund the activities of the various offices. For accounting and financial reporting purposes, operations in one of the cities are accounted for separately. All other activities are treated together, although separate profit and loss accounts (e.g., bonuses, etc) are maintained for various internal reasons for all separate city operations.

P determines whether it owns a foreign branch indirectly through HEx by applying Treasury Regulation §1.367(a)-6T(g)(1) separately to HEx and combining all of its Country X integral business operations. Because the Country X operations of HEx constitute integral business operations, either separately, as a whole, or in combination thereof, all such operations are combined and treated as a single foreign branch. Because all of HEx’s activities constitute integral business activities, HEx is not treated as having any income, gain, loss, or deductions that are allocated to it. Accordingly, while HEx is a separate unit that also is combined under the single country combination rule, its combination has no impact.

B. Defer U.S./Foreign Law Issues Until Relevant

We recommend that difficult mixed questions of U.S./foreign law be deferred, to the maximum extent possible, to when, if ever, they become relevant. The DRC, separate unit, and DCL definitions, combined with the no possible foreign use exception, we

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36 For an illustration of the complexities that can occur, see Rev. Rul. 81-82, 1981-1 C.B. 127.
believe, generally will cause most taxpayers to file domestic use elections. In our view, requiring that taxpayers be placed into the domestic use regime where a potential for double dip exists is a reasonable decision because it potentially avoids ever having to determine the difficult mixed U.S./foreign law issues involved in the election, except in the clearest of cases where the taxpayer can demonstrate no possible use. The objective, therefore, should be to treat the domestic use regime as creating a practical mechanism to identify and track such potential double dips within a specified period of time.

Consistent with this policy, taxpayers should not be subject to penalty if representations made in good faith at the outset to qualify for the domestic use election prove later to be incorrect. Rather, taxpayers should be allowed to enter the system, as long as they comply with the reporting and other procedural requirements of the regulations. Only if and when a triggering event occurs would it be necessary to expend the substantial resources to bring closure to these foreign law and foreign tax accounting issues. If a triggering event never occurs, then the substantial resources necessary to resolve the difficult U.S. and foreign law issues involved in the election would never need to be expended. Accordingly, the final regulations should make clear that in the context of a domestic use election, representations as to DRC and separate unit status, or to the amount of the DCLs associated with these operations, do not bind the taxpayer if the representations made in good faith are subsequently discovered to be mistaken. Furthermore, we believe that these changes should be allowed without regard to the reasonable cause exception that the Proposed Regulations would normally impose on taxpayers for procedural errors made in connection with the Proposed Regulations. We recommend that the following example be included in the final regulations to clarify the intended policy:

Example. P, a U.S. multinational company, is engaged in an active business throughout the world. P operates outside the United States principally through foreign corporations, but conducts certain operations through check-the-box foreign entities classified as disregarded entities and joint ventures classified as either regular partnerships or check-the-box partnerships. Each year P collects information to determine whether its foreign operations constitute a DRC, HESU, or foreign branch separate unit, and to determine the amount, if any, that may constitute a net operating loss associated with such operations. P files a domestic use election for each net operating loss that it believes its foreign operations that qualify as a DRC, HESU, or foreign branch separate unit generate, listing the type of entity and the amount of the DCL. Upon a triggering event that occurs for operations in Country X, P discovers that the amount of the DCL that was originally certified was incorrect, due to a clerical error that mistakenly booked charges to operations in Country X that should have been booked to other operations. Additionally, due to overhead costs allocated to a representative office that had been closed at the end of the prior taxable year, P discovers that it improperly treated these costs as a DCL. Even though P filed a domestic use election, P is not barred from correcting these errors upon a triggering event to which no exception applies. Furthermore, P can make these corrections without the advanced approval by the District Director for Field Operations.


38 We note that these representations are required to be made under penalties of perjury and thus are not made lightly. Given the complexity involved — both factually and legally — in such determinations, however, mistakes are made.
Consistent with our view that these difficult issues of mixed U.S./foreign law be deferred until relevant, we also believe that the requirement that taxpayers attach to their original return (including extensions) documentary evidence to support a no possible foreign use position is unnecessarily burdensome and costly.\textsuperscript{39} Such mixed U.S./foreign law determinations are not within the control of the taxpayer and can be determined at any time. Requiring taxpayers to incur the costs associated with such determinations up-front, before such issues are normally relevant, in our view, does not promote a fair and appropriate administration of the rules; but, rather, as with the representations that the taxpayer has a DRC or separate unit and the amount of the DCL, will only serve to potentially eliminate a valid defense against the application of the rules at a later point in time. We believe, given the up-front burden, that most taxpayers would elect to enter into domestic use agreements, rather than incur the up-front costs. In light of this, we recommend that the regulations clarify that taxpayers that are otherwise eligible to demonstrate no possibility of foreign use but elect to enter into domestic use agreements also retain the ability to argue at a later time, when a triggering event causes foreign use by reason of a change in law makes it relevant, that no DCL existed in the year in which it was incurred. Further, if there is a change in law in the foreign country, taxpayers should not be penalized.\textsuperscript{40} Thus, in our view, taxpayers should be allowed to demonstrate, when relevant, that they either had no DCL (under the foreign law in effect at the time the DCL had been incurred) or that under current law no foreign use is possible. This change could be accomplished by amending the rebuttal rules to make clear that changes in law made after the year that the DCL arose are not required to be taken into account in determining whether a foreign use has occurred in a prior year or could occur during the remaining certification period.

Finally, we recommend that taxpayers be given additional time to provide documentation to support the position that there is no possibility of foreign use of the DCL either up-front or upon a triggering event (\textit{i.e.}, during the remaining certification period). If a taxpayer was unable to gather the necessary documents in a timely manner, its only recourse would be to demonstrate to the satisfaction of the Director of Field Operations that its failure was due to reasonable cause and not willful neglect. To preclude the necessity of having to resort to the reasonable cause exception, we recommend that a taxpayer be required to provide only a statement under penalties of perjury of its intent to document its position that no possibility of foreign use exists, or to provide evidence to rebut a triggering event, with its original return (including extensions). Taxpayers would be required to provide the supporting documents within a reasonable period of time thereafter. An outer limit, \textit{e.g.}, a year, for providing such documents could be imposed.

\textsuperscript{39} Prop. Reg. §1.1503(d)-4(c)(2). Example 38 illustrates this burden.

\textsuperscript{40} For instance, if P elects to make a domestic use election, rather than avail itself of the “no possibility of foreign use” exception, P may find itself unable to rebut a recapture of the DCL upon a trigger event if foreign law changed to permit the use of the loss or deductions composing the DCL after the year in which the DCL had been incurred. \textit{Compare} Prop. Reg. §1.1503(d)-4(c) with -4(e)(2).
C. **Eliminate Basis Adjustment Rules**

We recommend that the special basis adjustment rules be eliminated. In our view, the basis adjustment rules are arguably inconsistent with the general intent of Congress that section 1503(d) not apply to capital losses and create inconsistencies in the application of the rules that raise issues of fairness.

The Proposed Regulations would continue the basis adjustment rules of the current regulations, which are intended to prohibit losses upon a subsequent sale of either the stock of a domestic affiliate or an interest in a partnership. Generally, where a DRC is a member of a consolidated group, members of the group owning stock in the DRC would be required to adjust their basis in the stock of the DRC in accordance with rules that depart in significant respects from the general consolidated return basis adjustment rules of Treasury Regulation §1.1502-32(b). The Proposed Regulations would require a downward basis adjustment in shares of a DRC for a DCL, even though the loss may not have been absorbed (whereas the general consolidated return rule is that a downward adjustment only occurs if the loss is absorbed), and would permit no upward adjustment in respect of income included by reason of recapture upon a triggering event.\(^{41}\) Where a separate unit is an interest in a partnership (itself a HESU or owner of a separate unit), the domestic owner's basis in the partnership would be adjusted in accordance with section 705 (basis reduced for a partnership loss without regard to whether it is absorbed by the partner), except that recapture of a DCL would not result in an increase in basis.\(^{42}\) The effect of these rules would be that a U.S. group that disposes of a DRC or separate unit in such a circumstance would never receive a U.S. tax benefit from the loss of the DRC. Apart from the DCL rules, the selling group would normally enjoy the benefit of a capital loss (or reduced capital gain).

We understand that Treasury/IRS are concerned that, without the special basis adjustment rules, taxpayers would be able to indirectly achieve a use of the DCL that they would otherwise be prohibited from using directly. While acknowledging this concern, we believe that these rules are arguably inconsistent with the general intent of Congress that the DCL rules not apply to capital losses. Section 1503(d) authorizes the disallowance of net operating losses, not capital losses, and the Proposed Regulations expressly acknowledge this.\(^{43}\)

Furthermore, we are troubled by the inconsistencies that the rules would create. These inconsistencies are highlighted by the following two examples:

**Example 1.** P owns the stock of a consolidated domestic company (“DC1”) that generates a DCL for which no domestic use election is made. P also owns the stock of an unaffiliated domestic company (“DC2”) that also generates a DCL for which no domestic use election is made. If P were to sell the stock of DC1 and DC2, absent the DCL regulations, a capital loss would be generated on the sale of each. In the case of the stock

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41 Prop. Reg. §1.1503(d)-3(d)(1).
of DC2, a non-affiliated domestic company, the capital loss would not be subject to the DCL regulations (apparently due to a perceived lack of authority). In the case of the sale of the stock of DC1, the proposed regulations would require a downward adjustment to P’s basis in the stock of DP1 and thus P would be denied a capital loss on the sale to the extent of the prior DCL.

Example 2. P owns HEx that owns the following two assets – an interest in HEy that is classified as a partnership for U.S. purposes and a capital asset. HEy operates in Country Y through FBY and in year 1 FBY generates a loss that is a DCL for which no domestic use election is made. On day one of year 2, HEx sells its partnership interest in HEy and its capital asset and both sales generate capital losses. The capital loss generated on the sale of the capital asset would not be subject to the DCL regulations. Because the proposed regulations would require that P’s partnership basis in HEy owned through HEx be adjusted downward to reflect the DCL of FBY in year 1, the capital loss generated on the sale of its partnership interest in HEy would be denied to the extent of the prior DCL.

Accordingly, although we recognize the concern of Treasury/IRS with potentially allowing an indirect use where a direct use would not be allowed, we believe that the more appropriate action would be to eliminate the special basis rules and provide a more consistent, and thus fairer, operation of the rule that capital losses not be subject to section 1503(d) limitation.44

D. Modify Mirror Rule

1. Background.

The so-called Mirror Rule provides that the domestic use election will not be available if a foreign country or jurisdiction has legislation that operates in a similar manner as the DCL rules to prevent the loss from use by another entity or separate unit in that country.45 The Mirror Rule has been the subject of much criticism and we were disappointed that the Proposed Regulations would not do more to reduce its scope.

The preamble explains the justification for the Mirror Rule and why it was retained. According to the preamble the “[the mirror] rule was designed to prevent the revenue gain resulting from the disallowance of the double-dip benefit of a dual consolidated loss from inuring solely to the foreign jurisdiction (to the detriment of the Untied States).”46 Despite acknowledging that the Mirror Rule can result in disallowing

44 We recognize that a taxpayer affirmatively elects to file a consolidated return, treatment of the group as a single entity is a general principle underlying the consolidated return rules, and that Treasury/IRS have the authority to prescribe rules for consolidated groups that are different from the provisions that would apply if the group members file separate returns. The single entity theory, however, is not complete in and of itself. It generally applies when necessary to clearly reflect the group’s income. The existing and Proposed Regulations actually distort the group’s income in this respect because a true economic loss is ignored. Given this, and the fact that section 1503(d)(2) does not apply to capital losses, we believe our recommendation is appropriate even in the consolidated return context.


losses in both countries, the preamble states that the rule was retained based on the legislative history and on the case law:

Given the relevant legislative history and British Car Auctions, the IRS and Treasury believe that the mirror legislation rules remain necessary. This is particularly true in light of the prevalence of mirror legislation in foreign jurisdictions. As a result, the proposed regulations retain the mirror legislation rule.47

We respectfully disagree with the preamble. In our view, Treasury/IRS have considerable leeway in drafting regulations to address mirror legislation. The legislative history that the preamble refers to is the Joint Committee on Taxation Explanation, not the House, Senate, or Conference Report.48 Although the Tax Court considered the Blue Book to be relevant as mirror legislation developed after the enactment by Congress of section 1503(d), it nevertheless is not binding on Treasury/IRS in our view. Additionally, the court in British Car Auctions, Inc. v. United States49 based its decision on the temporary regulations. There is nothing in the opinion to suggest that the court believed that the Mirror Rule would apply absent the temporary regulations. Accordingly, we do not believe it is a fair statement of the law that the Mirror Rule, as proposed, is one that is dictated by the “legislative history” or the “case law.”

We view it as positive that the Proposed Regulations would clarify that the “mere existence” of foreign country mirror legislation would not result in the DCL being deemed a “foreign use.” Also, they would clarify that a “foreign use” under the Mirror Rule would not constitute a “foreign use” for purposes of the “consistency rule.” Unfortunately, however, the Proposed Regulations relaxation of this policy does not take full account of its failure to have any meaningful effect in its 20-year history. We propose that the Mirror Rule be further restricted.

2. **Provide Stand Alone Exception from the Mirror Rule.**

The Proposed Regulations would provide that the absence of an affiliate in the foreign jurisdiction or the failure to make an election to enable foreign use (e.g., election to consolidate) would not prevent the opportunity for foreign use. As a result, the Mirror Rule would apply to disallow a DCL if a foreign country enacted mirror legislation notwithstanding that the DRC (or separate unit) had no foreign affiliates or had not elected to use the DCL to offset the income of affiliates in the foreign country.

We recommend that the Mirror Rule not apply to DRCs or separate units where no foreign affiliates exist that could potentially be denied the use of the loss under the mirror legislation of the foreign country. As currently written, losses incurred by a DRC or separate unit of a U.S. corporation would be disallowed (i.e., no domestic use election would be available) if the foreign country in which the separate unit or DRC operated had

47 Id.


enacted mirror legislation regardless of whether the branch or DRC had an affiliate in the foreign country or whether that affiliate generated income that the loss could be used to offset.50

In the case where the taxpayer has no affiliates, we are troubled by the conclusion that the taxpayer would be denied current deductibility of the loss in either country merely because if it acquired an affiliate in the future it might be denied the use of the loss to offset the income of such affiliate. We believe it inappropriate to apply the “no possible use” standard to deny the ability of a taxpayer to utilize a loss in either country simply because the taxpayer might acquire an affiliate in the future.51

As Example 4 of the Proposed Regulations illustrates, the standard that we recommend for the Mirror Rule would be consistent with the “no possible use” standard for determining whether a DCL exists. That standard would not restrict the ability of a taxpayer to make a domestic use election. Rather, because a potential exists that the loss could be used against affiliates in the future, the impact of the rule would be to merely require that the taxpayer comply with the regulatory regime, including allowing the taxpayer to make a domestic use election.

Accordingly, we recommend that the final regulations not apply the Mirror Rule to DRCs (or separate units) where no foreign affiliates exist. The Proposed Regulations should be modified to allow a taxpayer to use the DCL generated by DRCs (and separate units) in the United States if the taxpayer (i) demonstrates that no foreign affiliate exists that could use the DCL to offset its income; and (ii) certifies that if the losses are ever used to offset another foreign company’s income (e.g., NOL carryforwards used by a new foreign affiliate in a subsequent year) that the taxpayer would recapture the DCL used in the United States.

3. **Suspend Operation of Mirror Rule Even if Taxpayer Has Affiliates.**

We further recommend that the Mirror Rule be suspended even where a DRC or separate unit has affiliates, until greater progress is made to address these problems through bilateral agreements. Although a valid argument can be made for applying the Mirror Rule to situations in which the taxpayer has an affiliate and the domestic use of a DCL of a DRC (or separate unit) would be denied if an election to consolidate in a foreign country were made, we are troubled by the fact that taxpayers that economically

51 Although the effect of the mirror legislation may be to eliminate the ability of the taxpayer to choose to take its loss under foreign law, we believe that normally the absence of affiliates is motivated by business considerations, not tax restrictions on the utilization of losses in the foreign country. Accordingly, we believe that disallowing a taxpayer a potential deduction for the foreign loss merely because a foreign affiliate may one day exist (i.e., when no immediately available foreign use exists because there is currently no foreign affiliate) unfairly subjects the taxpayer to an economic hardship and arguably does no significance violence to the purpose of the Mirror Rule as there is no clear link in these circumstances to the existence of the mirror legislation and a detriment to the U.S. fisc.
incur a deduction or loss would be denied current deductibility of such deduction or loss in both countries. Absent a change in final regulations, the only potential for relief in these circumstances would be through a competent authority proceeding, assuming the foreign country has an income tax treaty with the U.S. Since the U.S. does not even allow domestic branches of foreign corporations to consolidate with affiliates in the United States, we believe that it would normally be difficult to persuade a foreign country to allow relief.

Additionally, taxpayers that would likely be impacted by the rule would often be those least likely to plan around the problem. For example, in our experience, taxpayers that operate through real branches in a foreign country, such as financial institutions, do so for valid business reasons. Thus, it is often impossible for these taxpayers to restructure their operations so that they are conducted through a foreign affiliate, for which at least a local deduction would be permitted on a current basis through consolidation. Even for taxpayers that can potentially restructure to avoid these problems, we question why taxpayers should be required to alter their business arrangements simply to obtain a deduction that the U.S. rules would otherwise allow.

Finally, we note that the Blue Book anticipated that the Mirror Rule would be applied only until agreements could be worked out by Treasury/IRS to allow a deduction in one of the two countries. Yet it has been almost 20 years since section 1503(d) was enacted and only this month has the first bilateral agreement been entered into by the U.S. to address these problems. Furthermore, this is the case even though the U.S. has negotiated income tax treaties since the enactment of section 1503(d) with the countries that currently have mirror legislation, namely, Australia, Germany, New Zealand, and the United Kingdom.

In light of these circumstances, we recommend that the final regulations temporarily suspend the operation of the Mirror Rule for situations in which taxpayers have affiliates but have not elected to consolidate under foreign law until progress can be made on bilateral agreements to address these problems. In the interim, taxpayers would be allowed to make a domestic use election, subject to the same requirements as above – that the taxpayer (i) demonstrates that no election has been made to use the loss against a foreign affiliate subject to the mirror legislation; and (ii) certifies that, if the DCL could have been used, absent the mirror legislation, to offset another foreign company’s income subject to the mirror legislation, the taxpayer would recapture the DCL in the United States.

The suspension could be provided by reserving on these situations in the final regulations. At the end of a reasonable time period, Treasury/IRS could publish a report on the progress in the various countries in resolving these issues and address at that time what, if any, further steps are necessary. From a tax policy standpoint, we believe that

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52 See, supra note 48.
53 United Kingdom – United States Dual Consolidated Loss Competent Authority Agreement (October 6, 2006), TNT Doc. 2006-20950.
this is a fairer and more rational way to address what, admittedly, is a difficult problem. Provided adequate efforts have been made to resolve these issues, the potential options for allowing a single deduction would be better understood and taxpayers would be more prepared to accept alternatives to address the problem. Furthermore, this would increase the priority to be given to resolving these issues on a bilateral context, where we believe that these issues properly should be resolved, rather than by placing the burden on taxpayers, which as we have discussed, in many circumstances have no practical recourse. Finally, by implementing this through a reservation, Treasury/IRS should still have sufficient leverage in negotiating these agreements to reach equitable results.

E. **NOL Computational Rules**

We applaud the efforts by the drafters to incorporate rules for computing a DCL. In general, we believe that the proposed rules would reach reasonable results.

1. **Allow U.S. Corporations With Foreign Branches To Use Treaty Method.**

   By far the most difficult computation rules to apply would be the rules proposed for foreign branch separate units. The Proposed Regulations would require that section 864(c) and Treasury Regulation §1.882-5 principles, with certain modifications, be used to determine net income or loss of a foreign branch separate unit. Most U.S. corporations are not familiar with these principles and, thus, requiring U.S. corporations to apply these principles would create complexity. Furthermore, in our experience, the section 864(c) rules often reach inappropriate results, as they provide that either all of the income or gain on a transaction be treated as effectively connected or that none of the income or gain on the transaction be treated as effectively connected. Thus, these rules raise inequities similar to those raised by the “all or nothing principle” for DCL recapture discussed in detail below.

   Despite these shortcomings, the proposed rules are not an unreasonable method for attempting to approximate what foreign law might tax as the net income or loss of a foreign branch separate unit and would provide a uniform standard to apply in these circumstances. Additionally, because the proposed rules for HEs that have foreign branches would only take into account the items of income and loss and the assets and liabilities of the HE (other than those attributable to the foreign branch or other intervening separate units), the application of section 864(c) and Treasury Regulation §1.882-5 principles to same country foreign branch operations of a HE would normally not reach a result substantially different than a booking rule. Accordingly, the

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54 One modification is that the principles of section 864(c)(2) and (c)(4) are to be applied by treating the domestic owner as a foreign corporation and the foreign branch as a U.S. trade or business. To clarify the source of the income for purposes of applying these principles, the final regulations should also provide that “the foreign country in which the foreign branch is located shall be treated as the U.S.”

55 Treas. Reg. §1.864-6 (c)(1).

56 Prop. Reg. §1.1503(d)-3(b)(vii).
complexity would occur where a U.S. company operates directly in a foreign country through a foreign branch separate unit (or through a non-hybrid partnership or grantor trust with a foreign branch separate unit) or indirectly through a HE that has a direct foreign branch separate unit (or non-hybrid partnership or grantor trust with a foreign branch separate unit) outside of its taxing jurisdiction. Although these circumstances do arise, in our experience such operations would more frequently arise in the financial community, as in many circumstances the business cannot be conducted through a HE. Because the section 864(c) regulations contain specific rules for banking and financing and because the §1.882-5 regulations were drafted primarily for these businesses, it may be that applying the rules to these types of operations would be workable.

Nevertheless, to alleviate the complexity that would otherwise arise and to bring the rules more in line with taxation under foreign law, we recommend two changes. First, U.S. corporations that operate direct foreign branch separate units (or through a non-hybrid partnership or grantor trust) should be allowed to use the method under the income tax treaty between the U.S. and the foreign country for determining the net income or loss of a foreign branch, provided the U.S. corporation applies that method for foreign income tax purposes. Although we agree with the general approach of the Proposed Regulations to provide a uniform set of rules, where the method being used for foreign purposes is sanctioned by the treaty between the U.S. and the foreign country and the taxpayer applies the treaty method, we believe that the taxpayer should be allowed to apply the treaty method. In these circumstances, we know of no reason that the DCL computations should not follow the foreign law computations, as the method has been expressly agreed to by the U.S. in the treaty. Not only would this simplify the rules, it would eliminate the all or nothing approach of the section 864(c) regulations (as treaties normally do not incorporate this principle) and bring the computations in line with the foreign computations.

Second, we recommend that the same treaty method be allowed for foreign branch operations conducted by a HE outside its home country (either directly or indirectly through a non-hybrid partnership or grantor trust), if the second foreign country also has a treaty with the U.S. and the U.S. corporation otherwise elects to use the treaty method.

Finally, if the U.S. corporation has entered into an advance pricing agreement (“APA”) with the foreign country on the taxation of the foreign branch, then the APA method should apply even if the APA was entered into prior to the effective date of the Proposed Regulations.

2. **Eliminate Reference to “U.S. Tax Principles” in Section 988 Properly Booked Rules.**

We recommend that the reference to “to the extent consistent with U.S. tax principles” in the reference to the section 988 booking rules that apply to HESUs be eliminated. Proposed Regulation §1.1503(d)-3(b)(2)(iii) provides that the “items of income, gain, deduction and loss attributable to a hybrid entity are those items that are properly reflected on its books and records under the principles of §1.988-4(b)(2), to the
extent consistent with U.S. tax principles.” The intent of the reference “to the extent consistent with U.S. tax principles” appears to be that if an item that is properly reflected on the books under the principles of §1.988-4(b)(2) is not a U.S. tax item (e.g., interest expense on a disregarded loan), it is not to be taken into account. Because the Proposed Regulations would separately make clear in §1.1503(d)-3(b)(2)(i) that such “items” would not be taken into account, the inclusion of a reference to U.S. tax principles in this context could be mistakenly read to imply that the section 988 booking rule requires that a disregarded item be taken into account. For example, under the Proposed Regulations, if a U.S. corporation were to borrow from a third party bank and on-lend to a DE that is a separate unit (or a foreign branch of the DE), the Proposed Regulations would not take into account the interest expense on the loan as it would be disregarded for U.S. tax purposes. Similarly, we believe that the section 988 booking rule would not require that the actual interest expense incurred by the U.S. corporation on its loan be treated as properly booked to the foreign branch. Yet the inclusion of the reference to “to the extent consistent with U.S. principles” raises some issues regarding this latter conclusion, especially since certain other places in the Code and regulations provide tracing rules for interest expense. Given that the Proposed Regulations already provide that “items” that are not treated as U.S. items would not be included in the computations, we believe that there is no need for this language. If it is believed that some qualification is necessary, then we recommend that the reference be “to the extent that such item is otherwise treated as an item of income, gain, deduction or loss under U.S. tax principles.”

F. Triggering Events (and Rebuttal) Rules

Modifications of the triggering events and rebuttal rules have the greatest potential for positive changes to the Proposed Regulations. We applaud the proposal to reduce the administrative burdens associated with the domestic agreement regime, by reducing from 15 to 7 years the time for monitoring against a prohibited foreign use. We also applaud the intent of Treasury/IRS to issue a revenue procedure that would address the all or nothing recapture principle. We discuss these below.

1. Reduce Period for Monitoring Foreign Use.

In our view, a more appropriate time for monitoring foreign use under the domestic use election regime is 5 years rather than the 7 years as proposed. As discussed above, Congress enacted the dual consolidated rules to address a narrow, abusive financing technique, in which a single consolidated group obtained two deductions through the interplay of differing residency rules. The Proposed Regulations expanded the scope of the rules to address all DRCs and foreign branch operations, regardless of the nature of the activities conducted, and the triggering events (discussed in more detail below) encompass all types of transactions in which loss carryovers may occur, including sales to unrelated parties. In our experience, most operations that are subject to the DCL regulations do not involve the type of abusive structures that Congress had in mind when it enacted section 1503(d). Additionally, given that the approach of the Proposed Regulations is to effectively force all domestic corporations with foreign losses into the

57 See, e.g., Treas. Reg. §1.163-8T.
domestic use election regime, we believe that requiring that taxpayers monitor foreign loss use for 7 years is prohibitively long. We believe that 5 years as is required for gain recognition agreements under section 367(a) is a more appropriate period. We strongly urge Treasury/IRS to make this change in finalizing the Proposed Regulations.58

2. **Provide Meaningful Exceptions to “All or Nothing Principle.”**

Probably the most troublesome aspect of the Proposed Regulations is the continuation of the requirement in the current regulations that a taxpayer recapture a DCL in its entirety, unless the taxpayer demonstrates that no amount of the deductions, losses, or expenses that make up the DCL can be made available for foreign use at any time after the triggering event, the so called “all or nothing principle.” Although we agree that the all or nothing concept, as embodied in the no possible use and foreign tax treatment disregarded standards, is appropriate for purposes of determining whether the DCL rules apply, we believe it entirely inappropriate to apply this concept upon a recapture event. Based on the discussions in the preamble, the drafters of the Proposed Regulations appear to agree with this conclusion, in concept, but decided against including exceptions due to administrative concerns that would be created by trying to reconcile U.S. and foreign law to make such determinations.59

As an initial matter, we question using administrative difficulties to justify denying deductions for taxpayers when the administrative difficulties are largely due to the expansive interpretation that Treasury/IRS have given to the statute. Congress enacted section 1503(d) in 1986 to address the use of a single economic loss to offset two separate streams of income through the ability to consolidation in both the United States and in a foreign country due to the differing concepts of residency. Thus, Congress provided for separate company treatment in the United States and delegated to the Treasury/IRS the authority to provide an exception where, under foreign law, the net operating loss does not “offset the income of any foreign corporation.” Two years later, in 1988, Congress became aware that some foreign countries allow foreign branch operations to consolidate with affiliates in the country and amended the statute to apply the rules to separate units. Treasury/IRS have consistently interpreted the 1988 statutory amendment to include losses of separate units as a Congressional mandate to cover all other forms of consolidation. Each set of regulations that Treasury/IRS have promulgated have applied section 1503(d) expansively, to cover virtually every circumstance in which double dipping of losses against two separate streams of income, one in the United States and one in a foreign country outside the United States, could potentially exist.

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58 If the time for monitoring the potential prohibited uses is not reduced to 5 years, we believe that a shorter period should apply for losses incurred by active businesses. Taxpayers do not engage in active foreign businesses to generate losses, and, therefore, active business losses should not raise the same level of concern. Although we acknowledge that active business operations some times are anticipated to incur start-up losses, we would be glad to work with you to develop an acceptable definition of an “active business” for this purpose.

In our view, the policy determination of whether to extend the statutory rules beyond situations that could be reasonably monitored (dual consolidation through DRC or separate unit participation in a consolidated return) should take into consideration the difficulties that extending the rules implies and the inappropriateness of implementing a system that, for determining whether a double dip has or might actually occur, virtually assures that the taxpayer will not be allowed to demonstrate that none of the DCL, in fact, was or ever will be double dipped. If Treasury/IRS are not willing to live with the complexity, then we believe this raises an important policy consideration as to whether the rules should be expanded beyond the abusive type situations which lead to the enactment of section 1503(d). Accordingly, if the conclusion is that the policy behind section 1503(d) justifies extending the rules to police foreign law double dips, which we believe is fair but certainly not mandated interpretation, then, in our view, that policy decision must accept a fairly significant degree of complexity. Accordingly, we believe that providing exceptions to the all or nothing principle is of critical importance to a fair and sensible application of the statutory rules as broadly interpreted.

3. Exclude Permanent Differences.

In our view, the “all or nothing principle” at least should be modified to exclude permanent differences in computing recapture amounts. As a result of differences between U.S. and foreign tax law, certain items that are deductible or subject to capitalization for U.S. tax purposes are not so treated for foreign law purposes. As illustrated in Example 38 of the Proposed Regulations, certain permanent differences may give rise to an NOL, and hence a DCL, for U.S. tax purposes but not a loss for local tax purposes. We recommend that an exception to the recapture rules be provided that would allow taxpayers to reduce their recapture amount by permanent differences, subject to the qualifications discussed in the text below.

As a threshold matter, we should clarify that we do not propose that the definition of a DCL be modified to account for such permanent differences even assuming Treasury/IRS have that authority to make such a change. In our view, applying the “all or nothing principle” in determining whether the DCL rules apply is an appropriate policy decision given the ability of taxpayers to elect into the domestic use regime. By

Ironically, the structures that section 1503(a) was originally aimed at now can be accomplished through economically equivalent transactions. For example, as the history to the section 894(c) regulations highlights, a reverse hybrid in the U.S. (partnership for foreign law purposes but corporation for U.S. tax purposes) that borrows from a third party bank and acquires a U.S. company will be entitled to deduct the interest expense against the operating company’s future income, while at the same time, in certain foreign countries, the deduction will flow through and thus can also be used to offset a separate stream of income in the foreign country of its owner. Similarly, as clarified by the Proposed Regulations, a U.S. company that borrows from a third party bank and loans to a DE that acquires a same country foreign operating company, can deduct the interest on the bank loan in the U.S. and, in most foreign countries, can also deduct the interest on the disregarded loan against the operating company’s income in the foreign country. One might question whether expanding the regulations to address hybrid entities when hybrid entities can be intentionally used to otherwise avoid the very structures that section 1503(d) was intended to address makes good policy sense without further consideration of the U.S. policy justifications behind policing transactions that result in foreign tax benefits.
providing an exception from recapture under the domestic election regime -- rather than from the definition of a DCL -- the factual/legal issues involved in determining the amount of a DCL that might not be deductible under foreign law may never have to be addressed. As we have stated above, we believe that taxpayers should be encouraged to enter the domestic use regime, so as to avoid these types of administrative concerns. In our experience, most taxpayers would never be subject to recapture and thus, for example, issues of how permanent differences should be addressed would in most cases never be relevant.

The government rejected an item-by-item analysis of the amount to be recaptured in the existing regulations because of the administrative complexity of such an approach and because the government believed that the statutory language and legislative history reflected an intent to disallow a DRC’s or separate unit’s entire NOL, not specific components thereof.61 Although we acknowledge the potential for administrative difficulties in determining whether or not a particular item composing a loss or deduction could be used under foreign law, the Proposed Regulations do permit taxpayers to demonstrate this fact, although only if the entire DCL is composed of such items.62

Particularly in light of the government’s recognition that permanent differences may not provide a foreign benefit, its acquiescence in permitting taxpayers to demonstrate it under certain circumstances, and the expansive nature in which the regulations have interpreted the scope of the statute, we question why taxpayers would not be permitted to exclude permanent differences in computing recapture amounts under the domestic use election regime. As the government apparently recognizes, a loss or deduction that is not recognized for foreign purposes simply does not raise the concerns at which the DCL rules were enacted. Furthermore, Treasury/IRS have broad authority to condition exceptions from loss utilization under section 1503(d)(1)(B) in a manner that would take into account permanent differences.63 Accordingly, if the taxpayer provides documentation supporting the permanent difference, we believe the taxpayer should not be subject to recapture upon a triggering event relating to these amounts.64

Permanent difference may arise in many ways. For instance, if a domestic corporation acquires the stock of a domestic company with foreign branch operations in a transaction in which section 338(g) and (h)(10) elections are made, the target’s asset basis

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62 Compare Examples 38 and 40.
63 Section 1503(d)(1)(B) provides that exceptions to loss limitation may be provided “to the extent provided in regulations.”
64 Note that this recommendation would not resurrect the concerns with the existing regulations wherein taxpayers who believe that no foreign use is possible can simply take that position without filing any documentation. As discussed in the text above, under our recommendations permanent differences could only be used to reduce recapture, not to reduce the amount of the DCL if no domestic use election is made. Furthermore, as with other rebuttal statements, documentation would be required when relevant, e.g., upon a subsequent triggering event. See discussion in text, supra, at II. B.
would be stepped up for U.S. but not for foreign tax purposes. Similar results can occur as a result of section 754 elections. Permanent differences may also occur as a result of the different treatment of functional currencies, hybrid instruments, as is the case in Example 38, disregarded entities, or other base differences.

In order to treat permanent differences in a fair and appropriate manner, however, we acknowledge that all permanent differences should be taken into account that might impact the ability to double dip items otherwise involved in computing the DCL. Accordingly, in determining whether an item that creates a deduction for U.S. purposes that is not a deduction for foreign purposes (a permanent deduction item) should be excluded from recapture upon a triggering event, the following additional permanent items would need to be taken into account:

(i) Income for U.S. but not foreign purposes;

(ii) Expenditures that are deductions for foreign but not deductible (or capitalized into depreciable or amortizable assets) for U.S. purposes; and

(iii) Income for foreign but not U.S. purposes.

A similar requirement should also apply if the taxpayer asserts that the amount of the recapture should be reduced by an item of income that is not treated as an item of income for U.S. purposes but that is treated as an item of income for foreign purposes (a permanent income item).

Our experiences suggest that in the vast majority of cases multiple permanent items are unlikely to arise in a single fact pattern because differences in how U.S. and foreign law treat an item normally involve timing. Accordingly, we believe that, in most circumstances, the factual inquiry to demonstrate the permanent item would be limited. But if one or more of the three enumerated items were to exist, the taxpayer would be required to combine its permanent item with the other permanent items on a DCL-by-DCL basis. Only if the net of the all of these items resulted in a reduction would the taxpayer be allowed to remove the net amount from recapture upon a triggering event. Finally, in computing interest on the recapture, the regulations should provide that such permanent difference would not be considered to have given rise to a U.S. tax benefit.

The following examples illustrate these principles:

65 The domestic corporation needs to identify the relevant permanent differences in any case, by reason of allocating in accordance with section 1060.

66 For instance, generally Canada does not permit local entities to have a functional currency other than the Canadian dollar (CAD) for Canadian income tax purposes. Thus, a DE operating in Canada that has the USD as its functional currency may realize a loss, under section 988, from repayment of a CAD dollar obligation but such loss would not be recognized for Canadian purposes.

67 For instance, some jurisdictions permit tax-free gifting of assets. If a DE located in one of these jurisdictions makes a gift, depending on the circumstances, a loss may arise for U.S. tax purposes but not for local tax purposes.
Example 1. P owns DC. DC owns DEx that operates in Country X through FBx. DEx also owns FSy, a CFC, whose ownership is reflected on the books of FBx. Under the same country combination rule, the income and loss attributable to DEx and FBx in Country X are combined and treated as a single separate unit; accordingly, whether the ownership of FSy is attributed to FBx or DEx is irrelevant. As a result of section 338(g) and (h)(10) elections that were made when P acquired the stock of DC, the basis of the assets of DEx and thus FBx were stepped up for U.S. but not for Country X tax purposes. Additionally, the combined unit has borrowed funds from DC. In year 1, the combined unit has a DCL of $40 for which the P consolidated group files a domestic use election. The DCL of $40 is composed of the following items: the combined unit generated deductions attributable to the section 338 step-up of $20 and other deductions of $40. It also paid $5 of interest expense on the disregarded loan from DC, received a dividend of $5 from FSy that was exempt under Country X law, as Country X applies a territorial system of taxation, generated a net foreign currency gain of $5 that was not recognized for Country X purposes, and generated other income of $10. (Both DEx and FBx have a U.S. dollar functional currency for U.S. tax purposes but are required to compute gain or loss for Country X purposes in the EURO, the currency of Country X.) On day one of year 2, DC sells its interest in DEx to a foreign buyer and no gain or loss is generated on the sale (basis equaled value).

In computing the P group’s recapture amount, the year 1 DCL of $40 may not be reduced by the entire $20 of permanent section 338 deductions. Rather the $20 of permanent deductions must be combined with the other permanent items in year 1. Thus, the $20 of section 338 deductions must be reduced by the $5 of interest expense that is recognized under foreign but not U.S. law, the $5 of dividend income that is recognized under U.S. law but not under foreign law, and by the $5 of net foreign currency gain that is recognized under U.S. law but not under foreign law. Accordingly, assuming that the P group is unable to prove that no foreign use is possible with respect to the other items of deductions that make up the year 1 DCL, the group would recapture $35 of the year 1 DCL of $40, along with an interest charge based on a year 1 benefit of $35.

Example 2. The facts are the same as Example 1, but FBx also earns $35 in year 1 of other income for U.S. and Country X purposes. The P group would not be subject to recapture in year 2 or in any other year and would not be subject to an interest charge.

Example 3. P owns DEx that operates in Country X through FBx. DEx also owns the stock of a FSy, a CFC, whose ownership is reflected on the books of FBx. Under the same country combination rule, the income and loss attributable to DEx and FBx in Country X are combined and treated as a single separate unit; accordingly, whether the ownership of FSy is attributed to FBx or DEx is irrelevant. The functional currency of CFC is the U.S. dollar and the functional currency of DEx and FBx is also the U.S. dollar. In year 1, FSy generates $100 of subpart F income that is included in the income of P and also included in the income of its Country X combined unit in computing its net income or loss for DCL purposes. As a result of the subpart F inclusion, the combined unit generates net income in year 1 of $50 for U.S. but not foreign law purposes. In year 2, CFC makes a dividend distribution of $100 that is considered, under U.S. law, to be a distribution of previously taxed income as defined in section 959, but, under Country X law, to be a taxable dividend. In year 2, the combined unit generates a net operating loss of $50 and P makes a domestic use election. On day one of year 3, P sells its interest in DEx for an amount equal to its basis for U.S. tax purposes in what would otherwise constitute a triggering event. P asserts that it should be allowed to reduce its $50 year two DCL recapture amount to zero, on the basis that the year 2 dividend is a permanent income item, as Country X taxed the years 2 distribution as a dividend but the U.S. treated it as previously taxed income. Because the year 2 dividend represents a timing difference, as the U.S. taxed the same income to the combined unit in year 1 as subpart F income, the reduction in the amount of the recapture
on this basis is not allowed. P, however, is allowed to reduce the amount of the year 2 recapture by the $50 of net income generated by the combined unit in year 1.

We further recommend that Treasury/IRS provide a list in the contemplated revenue procedure of permanent items, such as illustrated in the examples above, that must be taken into account. As a matter of administration, we recommend that Treasury/IRS make this an exclusive list. We would be glad to work with you on the items, others than illustrated above, that should be included in such list.

Finally, the treatment of permanent items that we recommend raises two additional issues that are illustrated in Examples 4 and 5 below.

**Example 4.** Assume the facts are the same as in Example 3, except Country X does not tax the $100 dividend CFC paid in year 2. Upon the audit of year 1, the agent asserts that the combined unit should have been required to reduce its year 1 taxable income of $50 by the $100 of subpart F income, as the $100 of subpart F income represents a permanent income difference, and thus a DCL of $50 should have been reported in year 1. Because under U.S. principles no net operating loss exists in year 1, the agent is not permitted to make this adjustment. Furthermore, in year 3, P may reduce its recapture amount attributable to the year 2 DCL of the combined unit of $50 by its $50 of year 1 income.

As the conclusions in Example 4 illustrate, a certain unfairness exists in allowing the taxpayer to reduce its recapture amounts by permanent differences but not allowing the IRS to create, or increase, a DCL where a permanent item reduces the net income, or increases the net loss, of the separate unit or DRC. One alternative we considered but rejected to address this inequity is to deny P the ability to reduce its year 3 recapture by the $50 of year 1 net income of the combined unit. Although this would be an acceptable result in the facts of Example 4, such a rule would effectively treat the year 1 amount as a DCL. Thus, we are concerned that imposing such a restriction would create inconsistencies in the application of the rules that from a policy standpoint do not seem acceptable. For example, if the combined unit generated its additional $50 of year 1 net income in year 2, no net operating loss for U.S. purposes would exist in any year at issue and the DCL rules would not have applied at all. Yet under the facts of Example 4 if such a restriction were applied, P would be subject to recapture merely because it generated net income in year 1 rather than year 2. The only way to then apply the rules in a consistent manner would be to redefine what constitutes a DCL by reference to U.S. and foreign law, which we believe is not advisable from an administrative standpoint, as discussed above.

Example 4 also highlights whether the computation rules, as opposed to the DCL definition more broadly, should be modified to focus more closely on foreign law concepts to limit potential inconsistencies in the application of these rules to income items, such as illustrated above. For example, presumably the proposed computational rules could be altered to provide that the subpart F income of P in Example 4 should not be reflected in the income of the combined unit unless it would be taxable to the combined unit under foreign law. Example 5 illustrates a similar rule would be necessary for deductions.
Example 5. Assume that the facts, again, are the same as in Example 3, but DEx is not a disregarded entity. Rather its activities are conducted directly by P and thus constitute a directly owned foreign branch, and P has additional expenses, of $75, that are not allocated to the foreign branch under U.S. principles, but that Country X allocates to it under their laws. In year 3, P may reduce the recapture amount of its year 2 DCL of $50 by the $50 of income earned by the foreign branch in year 1.

Although conceptually appealing, we are concerned that without a uniform set of U.S. computational rules the administration of the DCL regime would become even more difficult to apply and would create issues on audit that we believe are better left to when, if ever, they become relevant. Accordingly, in our comments on the computational rules, set forth above, we limited our recommendations for conformity to foreign law to situations where conformity would be consistent with established U.S. principles, such as applying treaty concepts for computing foreign branch income or loss. Not every inconsistency between U.S. and foreign tax principles can be eliminated. Thus, we do not recommend that the proposed computational rules be altered to focus more closely on foreign law concepts to limit potential inconsistencies in the application of these rules to income or deduction items.

Furthermore, the deductions of P in Example 5 that are allocated to the foreign branch unit under foreign but not U.S. law are permanent only in the sense that they exist for foreign but not U.S. law as to the foreign branch. If recapture was increased by these items, or if similar items were allowed to reduce recapture (for example, in the case where deductions are allocated to the branch for U.S. but not foreign law purposes), we are concerned that the rules we have recommended for addressing what we believe are narrow situations where items exist under one system but not under the other system (such as in Example 1) would be more difficult to apply, as potentially any item would be a permanent item. Additionally, it would make it impossible to provide a comprehensive list of permanent items that could be used in applying these rules to assure that all permanent items are appropriately accounted for. Accordingly, we would not recommend that the types of items illustrated in Example 5 be treated as permanent items.

4. **Address Timing Differences.**

Although permanent differences raise the greatest concern, because they can never be subject to double dipping, the failure of the Proposed Regulations to provide exceptions for timing differences in determining recapture also creates significant policy concerns. Under the “all or nothing principle,” even one dollar of a timing difference would give rise to recapture of the entire DCL. Additionally, even if the taxpayer can demonstrate with certainty that a certain portion of the DCL cannot be double dipped, it will be required to recapture the entire DCL. We believe that such treatment is inappropriate and that further rules are necessary to address these inequities.

The single biggest policy decision we believe the treatment of timing issues raises is whether the recapture rules should attempt to address these issues in a non-factual manner; that is, by providing a set of rules that would attempt to approximate the treatment under foreign law, or whether a factual analysis of U.S. and foreign law will be
allowed, or some combination of the two. Although we are sympathetic to the desire to avoid analysis of foreign law, we believe, as discussed above, that some exceptions based on foreign law are demanded if the regulations are to operate in a fair and appropriate manner. We understand that this will require some creative thinking to balance the interest of Treasury/IRS that the system be administrable with the desires of taxpayers that they be allowed to demonstrate that some portion of their losses have not been, or are unlikely to be, double dipped.

Rather than attempt to address all the potential ways in which this balance might be struck, we have decided to wait to provide specific comments until the issuance of the proposed revenue procedure discussed in the preamble to the Proposed Regulations is issued. This decision is based, in part, on our view that the list of issues that the preamble explains are being considered is consistent with our general views of the problem areas.

Nevertheless, we do wish to express our support for providing an exception in the final regulations that would allow the IRS to enter into a closing agreement to avoid recapture in appropriate circumstances. For example, a closing agreement exception to address transfers to foreign persons where adequate safeguards to assure that a recapture tax would be collected (for example, where the foreign person had U.S. subsidiaries and the U.S. subsidiaries were willing to agree to serve as agents for assessment of tax against the foreign person) and where assurances that future treatment of any carryover attributes could be monitored would be useful. In our experience, often these transfers do not raise a significant likelihood that any portion of the DCL would, in fact, ever be made available for use under foreign law, but taxpayers in these situations would have no viable option to otherwise avoid recapture.

III. RESPONSE TO COMMENTS REQUESTED ON OTHER ISSUES

A. **Application of Rules to REITs and RICs**

The preamble to the regulations requests comments on whether Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs), like Subchapter S corporations, should be exempt from the regulations. Because Subchapter S corporations cannot have Subchapter C corporation shareholders, the Proposed Regulations do not apply the dual consolidated loss regulations to Subchapter S corporations or to operations of a Subchapter S corporation that could constitute a foreign branch separate unit. Although REITs and RICs are generally flow-thru entities like Subchapter S corporations, REITS and RIC can have Subchapter C corporation shareholders. Additionally, REITS and RICs can be engaged in foreign investments and can operate through entities that would be DRCs and separate units. The drafters of these comments, however, are not aware that this issue has caused any significant concerns among taxpayers that operate through REITs and RICs. Accordingly, we have not responded to this request.

B. **Treatment of Section 987 Gain or Loss**
The preamble to the regulations requests comments on section 987 gain or loss and the effect of inserting a hybrid entity between a U.S. parent and its foreign branch. Section 987 requires a U.S. corporation that owns a foreign branch (qualified business unit) having a functional currency different from that of the corporation generally to compute gain or loss on a remittance of property from the foreign branch. Under section 987, that gain or loss is not considered to be gain or loss of the foreign branch and we believe that it also should not be treated as gain or loss of the foreign branch for section 1503(d) purposes if the U.S. person owns the foreign branch directly or owns a HESU operating only in the currency of its place of organization. If the foreign branch is owned, indirectly, through a HESU, it may be appropriate to apply section 987 at the HESU level, but we believe that the appropriate course of action is to wait until the anticipated new Proposed Regulations under section 987 are issued to address this issue.

IV. OTHER TECHNICAL ISSUES

A. Application of Dilution Rule Component of Foreign Use

We recommend that the proposed ownership dilution rules clarify that the ownership dilution rules apply only if some portion of a DCL would otherwise be made available for use under foreign law. We read the ownership dilution rules to require a foreign use only if the some portion of the DCL would otherwise be made available to offset income or gain under foreign law, as the ownership dilution rules are an exception to an exception to the general made available rule in Proposed Regulation §1.1503(d-1(b)(14)(i) and under that general foreign use rule a foreign use occurs only if a portion of 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 . . . .” An example, however, would usefully clarify this point. For example, a taxpayer should be allowed to demonstrate that no foreign use occurs if no portion of the DCL of a hybrid entity partnership could be used by the foreign contributor because of foreign law restrictions (e.g., a change in ownership provision that eliminates the loss). As another example, a taxpayer should be allowed to demonstrate that no foreign use occurs if at the time the foreign person contributes cash to the partnership in exchange for its partnership interest, no timing differences exist under U.S. and foreign law that would permit the potential use of any portion of the DCL that was recognized for U.S. and foreign purposes prior to the ownership dilution. Some sort of de minimis rule is also necessary here.

B. Section 986(c) Gain or Loss

The Proposed Regulations do not include section 986(c) gain or loss in the rule for income inclusions on stock. Proposed Regulations §1.1503(d)-3(b)(viii)(D) provides that income (such as subpart F income and section 78 gross-ups) of a U.S. person arising from ownership of stock through a separate unit is to be taken into account by the separate unit if an actual dividend distribution would have been so taken into account. Section 986(c) provides for gain or loss on distributions of previously taxed income from a foreign corporation that has a different functional currency than its U.S. owner. Section 986(c) gain or loss arises from the distribution of previously taxed income, not as a result
of a deemed inclusion, and thus the above rules literally would not apply to section 986(c) gain or loss. The final regulations should modify the stock income inclusion rules to make clear that section 986(c) gain or loss is intended to be treated similarly to subpart F income and section 78 gross-ups, by providing that section 986(c) gain or loss on a distribution, or deemed distribution, will be treated as income or loss in accordance with the way in which the distribution, or deemed distribution, is treated for section 1503(d) purposes.

C. Domestic Use Election -- Section 384 Required Treatment

To make a domestic use election, a subsequent elector must agree to treat “any potential recapture amount under paragraph (h) of this section with respect to the dual consolidated loss as unrealized built-in gain for section 384(a) purposes, subject to any applicable exceptions thereunder.” Under section 384(a), one of the two corporations involved in the transaction must be a “gain corporation.” In order to be a gain corporation, a corporation must have a “net unrealized built-in gain.” A corporation will not be considered to have net unrealized built-in gain unless the net unrealized built-gain exceeds the lesser of 15 percent of the fair market value of its assets or $10 million. We assume that the requirement that any potential recapture income must be treated as “unrealized built-in gain” for section 384(a) purposes does not mean that this threshold does not apply. Further, based on the qualification “subject to any applicable exceptions thereunder,” we assume that the requirement to treat potential recapture amounts as “unrealized built-in gain” only applies if the transaction itself is subject to section 384. Thus, for example, if a HE separate unit of a domestic company were transferred to another U.S. company in a fully taxable transaction, this requirement would not apply as section 384 would not apply. In our view, the DCL regulations cannot require taxpayers to enter into a domestic use election that would bind the taxpayer to an even greater limitation on the treatment of unrealized built-in gain than would otherwise apply under section 384.

Also unclear is the issue of how the threshold is to be determined, as recapture income is subject to reduction for income earned by the separate unit or DRC. Is the taxpayer required to assume the full amount of the DCL would be recaptured at the time of the ownership change, or is the taxpayer allowed to make the appropriate reductions at that time?

D. Recapture – Example 52

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68 Although there are no regulations issued under section 986(c), Notice 88-71, 1988-2 C.B. 374, provides that section 986(c) is required to be recognized on certain transactions subject to section 1248. Treasury Regulation §1.367(b)-2(j)(2) also requires similar section 986(c) inclusions in certain circumstances that could impact DCL computations.


70 I.R.C. §384(b)(4).

71 See I.R.C §§384(c)(8), 382(h)(3).
The Proposed Regulations would provide that the recapture amount upon a triggering event may be reduced by income generated under U.S. tax principles by the separate unit or DRC subject to the limits set forth in Proposed Regulation §1.1503-3(c)(3), which incorporate the SRLY rules of Treasury Regulation §1.1502-21(c) with certain modifications. As demonstrated by Example 52, this results in the recapture amount not being reduced by income generated in a subsequent taxable or prior year by the separate unit or DRC if in that year the consolidated group overall had insufficient taxable income to absorb the loss.

Although the requirement to limit the use of SRLY losses to only years in which the consolidated group has sufficient income to offset the losses may be appropriate in the consolidated return context, in our view it is not appropriate in the DCL context. The focus of the recapture rule in the DCL context should be on whether the loss would have been offset by the income of the separate unit or DRC, as the import of the rules is to prohibit double dipping. Where the same operations have generated both loss and income under U.S. principles, there is no possibility of a double dip and the rules should acknowledge this by allowing the losses to offset income on a separate computational basis without regard to the other activities of the consolidated group. Accordingly, we recommend that the recapture amount be reduced by the income generated by the separate unit or DRC in such subsequent or prior taxable year whether or not the consolidated group has sufficient taxable income in that year.

Pursuant to our recommendation, Example 52, with revisions noted below, would provide as follows.

Example 52. Reduced recapture and interest charge, and reconstituted dual consolidated loss. (i) Facts. P owns DRCx, a member of the P consolidated group that operates a foreign branch in Country X (“FBx”). In Year 1, FBx incurs a dual consolidated loss of $100x and P earns $100x. P makes a domestic use election with respect to FBx's Year 1 dual consolidated loss. Therefore, the consolidated group is permitted to offset P's $100x of income with DRCx's $100x loss. In Year 2, FBx earns $30x, which is completely offset by a $50x net operating loss incurred by P in Year 2. In Year 3, FBx earns income of $25x, while P recognizes no income or loss. In addition, there is a triggering event at the end of Year 3.

(ii) Result. (A) Under the presumptive rule of section 1.1503(d)-4(h)(1)(i), DRCx must recapture $100x. However, the $100x recapture amount may be reduced by the amount by which the dual consolidated loss would have offset other taxable income if it had been subject to the limitation under section 1.1503(d)-3(c)(3), upon adequate documentation of such offset under section 1.1503(d)-4(h)(2)(i).

(B) Although FBx earned $30x of income in Year 2, the consolidated group generated a $20 net operating loss. Nevertheless, under section 1.1503-3(c)(3), the $100x of recapture income may still be reduced by the $30x earned in Year 2. The net operating loss for the group, however, is unaffected by this treatment and thus remains $20. In Year 3, FBx earns $25x of income and the P consolidated group has $5 of consolidated taxable income in such year after applying its net operating loss carryforward from Year

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2 of $20. Because FBx generated $25 of income in Year 3, the remaining $70x of recapture income can be reduced by the $25x.

(C) Commencing in Year 4, the $45x recapture amount ($100x - $30x - $25x) is reconstituted and treated as a loss incurred by FBx in a separate return limitation year, subject to the limitation under section 1.1503(d)-2(b) (and therefore subject to the restrictions of section 1.1503(d)-3(c)(3)). The carryover period of the loss, for purposes of section 172(b), will start from Year 1, when the dual consolidated loss was incurred. Pursuant to section 1.1503(d)-4(i)(3), the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated of FBx is terminated and has no further effect.

V. EFFECTIVE DATE RECOMMENDATIONS

We recommend that taxpayers be allowed to elect to apply the reduction in the monitoring period, from 15 to either 7 or 5, as we have requested, retroactively. Without some ability to apply the reduced period to existing agreements filed under Treasury Regulation §1.1503-2(g)(2) (“(g)(2) agreements”), taxpayers will have to comply with differing recapture rules and periods, even for the same separate unit or DRC. We believe this would create unnecessary complexity. We are concerned, however, that merely providing for a reduction in the recapture period for existing (g)(2) agreements would allow taxpayers the benefit of a reduced recapture period without subjecting them to the new recapture rules.

Thus, we recommend that the general rule be that taxpayers that have filed (g)(2) agreements would continue to be subject to the old regulations, including the recapture and other rules. However, we recommend that taxpayers be allowed to elect to replace their existing (g)(2) agreements covering the DCL amounts as determined under the old regulations with a new domestic use agreement, provided that the taxpayer is otherwise able to file the agreement, including the ability to certify that no foreign use under the new regulations has occurred in any year since the original (g)(2) agreement was filed. In the case of (g)(2) agreements covering DCLs that have been subject to a closing agreement(s), we recommend that all parties that are jointly and severally liable consent to the filing of new agreements and that new agreements be filed by all such parties. We also recommend that the election to replace be subject to a consistency rule that would require that all (g)(2) agreements must be replaced, with an exception for (g)(2) agreements covering DCLs for which a prior closing agreement is involved, since multiple parties must consent to replace. Additionally, we recommend that taxpayers be allowed to file a single agreement to replace more than one (g)(2) agreement, provided each DCL is separately stated.

We also recommend that taxpayers be allowed to elect to apply the regulations retroactively for all open years to DCLs for which no (g)(2) agreement is outstanding, subject to the same consistency requirements. Taxpayers that are subject to the SRLY regime should not be precluded from applying the regulations retroactively, including potentially being allowed to file a domestic use election if the regulations would allow an election that was not allowed under the old regulations. Moreover, if the effect of such an election would be to eliminate the DCL from recapture due to the reduced monitoring period, the taxpayer should be allowed to simply note this on the attachment to its return.
Finally, we believe that consideration should be given to making certain of the changes that have been acknowledged as “clarifications” in the preamble to the Proposed Regulations effective retroactively whether or not the taxpayer elects to apply the new regulations.