New York State Bar Association
Tax Section

Report on Proposed Dual Consolidated Loss Regulations

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New York State Bar Association
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Report No. 1100

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I. INTRODUCTION

On May 25, 2005, the Department of Treasury (the "Treasury") and the Internal Revenue Service ("IRS") released proposed regulations ("Proposed Regulations") under Section 1503(d) of the Internal Revenue Code of 1986, as amended (the "Code")[1], relating to dual consolidated losses ("DCL"). The Proposed Regulations would substantially revise the existing regulations ("Current Regulations")[2] restricting double use of losses by dual resident corporations and transparent entities. This report contains the suggestions and comments of the New York State Bar Tax Section (the "Section") regarding these proposed regulations.

We welcome the efforts of the Treasury and the IRS in addressing this long overdue regulation project.[3] The weaknesses of the current regulations have been frequently observed.[4] The Proposed Regulations modify the Current Regulations in several positive ways including: (i) the rationalization of the branch combination rule, (ii) the reduction of SRLY'd items resulting from a DCL to a proportionate share of the deductions constituting the loss instead of all items, (iii) the shortening of the certification period for domestic use election(s) to seven years from 15 years, and (iv) the soon-to-be published revenue procedure expanding opportunities for the rebuttal of domestic use election recapture. In addition, the expanded hybrid entity definitions and the 52 numbered examples contained in proposed Regulation § 1.1503(d)-5 resolve many unanswered questions.

This report begins with a summary of our recommendations. Then it provides a history of the dual consolidated loss provision and an explanation of current law. The report thereafter sets forth a detailed discussion of the significant changes set forth in the Proposed Regulations, including a discussion of our suggestions for further improvements.[5]

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[1] Hereinafter, all sectional references refer to the Code unless otherwise indicated.
[2] Treas. Reg. § 1.1503-2, T.D. 8434, 1992-2 C.B. 240 (hereinafter referred to as the "Current Regulations").
[3] The preamble to the Proposed Regulations refers to the Internal Revenue Service and the Treasury as the source of the Proposed Regulations. This report will refer to the Treasury only for brevity.
[4] *See, e.g.* David R. Hardy, *Company Without A Country*, Tax Notes Today (1999); Peter Blessing, *Dual Consolidated Losses,* Tax Notes Today (May 28, 2003); K. Krupsky, *DCL Regulations: the Mirror is Cracked*, 32 Tax Management International 155 (March 14, 2003).
[5] The principal author of this report is David R. Hardy. Significant contributions were made by David S. Miller, David P. Hariton and Willard B. Taylor. Helpful comments were provided by Kimberly S. Blanchard, Michael L. Schler, Peter Blessing, Stephen Land and Andrew Solomon.

A. General Recommendations.

1. Use of Foreign Law.

The dual consolidated loss rules are fundamentally concerned with "double dipping" – that is, using losses to reduce U.S. tax and then again using them to reduce the foreign taxes of another foreign entity. However, for reasons of administrability, the Current Regulations and the Proposed Regulations avoid references to foreign law.

This decision to ignore foreign law denies some U.S. taxpayers the use of losses (or requires their recapture), even though there is no actual foreign use of these losses, and permits other taxpayers to double dip losses in a manner that is contrary to the policies underlying the statute. Thus, for example, the "all or nothing" rule of the Proposed Regulations requires a U.S. taxpayer that uses dual consolidated losses under a "domestic use" election to recapture all of its losses, even if only a tiny amount may be inadvertently used by another foreign entity to reduce its foreign tax liability. Conversely, the Proposed Regulations would not attribute interest expense incurred by a U.S. taxpayer to a foreign disregarded entity (and therefore would not subject any losses generated by the interest expense to the dual consolidated loss rules), even if foreign tax law would so attribute the interest expense and therefore the same interest expense could reduce the U.S. taxpayer's U.S. tax liability and a different foreign entity's foreign tax liability. Thus, foreign law is fundamental to determining whether any double dip exists, but the Proposed Regulations ignore foreign law.

We believe that the Proposed Regulations strike the wrong balance in each of these cases, and that foreign tax law should be more relevant for purposes of the dual consolidated loss rules than the Proposed Regulations would allow. We would address the IRS's and Treasury legitimate concerns about administrating U.S. tax laws based on foreign tax laws by placing the burden of proof on taxpayers to demonstrate foreign tax law and foreign tax consequences to the satisfaction of the IRS.

2. Consistent Rules of Double Dips

For the policies underlying the dual consolidated loss rules to be implemented fairly, we believe that the rules should be consistently applied to similar transactions. Yet we note that results similar to the results that Congress intended to prevent with the dual consolidated loss rules are possible without implicating the dual consolidated loss rules, and we recommend that consideration should be given to rationalizing these anomalous results. For example, if a U.S. corporation organizes a hybrid entity in a foreign country and that foreign hybrid entity borrows funds from an unrelated lender and generates losses, the losses are dual consolidated losses. However, if instead, the U.S. corporation borrows the funds from the unrelated lender (and generates interest deductions), and loans the funds to the hybrid entity, the parent is not

subject to the dual consolidated loss rules with respect to its own interest expense and the hybrid entity's losses that arise from the interest expense paid to its parent are not subject to the dual consolidated loss rules (because the loan by the U.S. corporation to its disregarded entity is ignored for all U.S. tax purposes). We wonder whether these two similar factual situations should produce such different results.

B. Summary of Specific Recommendations

Summarized here are the suggestions that we believe would improve the Proposed Regulations.

1. All or Nothing Rule. Consistent with the general recommendations above, we recommend that the "all or nothing rule" be eliminated and that a U.S. taxpayer be permitted to avoid recapture of its dual consolidated losses that are used under a domestic use election to the extent that the taxpayer can demonstrate to the satisfaction of the IRS that the losses are not in fact used under foreign tax law. As a corollary of this change, a partial foreign use in the year of a loss should not prevent a taxpayer from making a domestic use election as to the remainder of its dual consolidated loss.

2. Interest Attribution to a Branch. The Proposed Regulations would attribute interest expense of a U.S. corporation to its foreign natural branches under the principles of Regulation § 1.882-5, but not to hybrid branches. Consistent with the above, we believe that if a taxpayer can demonstrate to the satisfaction of the IRS that foreign law in fact does not attribute interest expense of the taxpayer to the taxpayer's natural foreign branch, then the interest expense should not be attributed to the branch. Conversely, we believe that interest expense should be attributed to a hybrid branch if foreign law in fact attributes such interest expense to the hybrid branch.

3. Exclusion of Separate Unit Dividends. Under the Proposed Regulations, separate units are treated as U.S. subsidiaries, and their income for purposes of the dual consolidated loss rules is calculated under consolidated return principles. Consistent with the consolidated return rules, distributions from a lower tier separate unit to a higher tier separate unit are excluded from income either as branch remittances or as excluded dividends. As a result, if a recipient unit is using distributions from a lower tier separate unit to service interest on debt financing, a dual consolidated loss results. We recommend either that the Proposed Regulations treat each unit as a separate U.S. corporation (and not exclude the distributions from a lower-tier separate unit), or else (consistent with our general recommendation) permit the taxpayer to demonstrate to the satisfaction of the IRS that the distribution received by a separate unit from a lower-tier separate unit is taxable under foreign tax law (and is not excluded under a participation exemption or otherwise).

4. Separate Unit Combination for Related Units. The Proposed Regulations state that separate units owned directly or indirectly by the same U.S. owner, which

otherwise qualify for unit combination, may be combined for purposes of determining the existence of a DCL. The Preamble asks for comments as to whether separate unit combination should be extended to otherwise qualifying units owned by different corporations belonging to the same U.S. consolidated group. We believe that separate unit combination is a useful rule. Separate units owned by different members of a consolidated group could generally be restructured into a relationship that permitted combination. We recommend that the combination privilege be extended to such units without the necessity of restructuring. We believe that the SRLY limitation could be administered on a proportionate basis in a manner similar to the way the Proposed Regulations impose the SRLY limitation on a proportionate share of expense and loss items.

5. Extend Separate Unit Rules to Foreign Owned Units. The 1988 statutory amendments extended the dual consolidated loss rules to foreign separate units of U.S. corporations. At that time, it was not necessary to extend the rules to U.S. units of foreign corporations because they could not consolidate with their U.S. affiliates. Since the check-the-box rules were promulgated, U.S. units of foreign corporations may effectively consolidate with their U.S. affiliates. Recognizing this, we recommend that the Proposed Regulations be extended to U.S. units owned by foreign persons. This change would restore the consistent application of the dual consolidated loss rules to inbound and outbound transactions as well.

6. Partnership Dilution Recapture. Under the Current Regulations, a DCL that is the subject of a domestic use election is recaptured following a "foreign use". The Proposed Regulations would define foreign use to include dilution transactions. We understand this rule to be a change from the Current Regulations, rather than a mere clarification, and believe that this rule is appropriate if the "all or nothing rule" is eliminated. However, if, contrary to our recommendation, the all or nothing rule is retained, we recommend that a dilution not require recapture if the taxpayer demonstrates to the satisfaction of the IRS that the dilution event does not permit the foreign holder to use the losses of the dual resident corporation or unit.

7. Eliminate the Mirror Rule. Under the "mirror rule", if a foreign jurisdiction enacts legislation that "mirrors" the U.S. dual consolidated loss rules and disallows foreign use of a loss, a dual resident corporation is deemed to have engaged in a foreign use of the loss that prevents a domestic use election or causes recapture of a previous domestic use election loss. This rule should be eliminated. A taxpayer should be allowed to make a domestic use election for such loss. We recommend that the Treasury promulgate a mandatory competent authority procedure or similar arbitration to prevent the United States from bearing the entire amount of a dual consolidated loss in such instances.

8. Basis Adjustment. The Proposed Regulations would continue the special basis adjustment rules of the Current Regulations. Under these rules, a dual consolidated loss permanently reduces the basis of the U.S. owner in a dual resident corporation, even if the U.S. owner makes a domestic use election and is subsequently subject to recapture. Thus, this rule punitively requires both recapture and basis reduction. We recommend

that the rule be changed. If a U.S. taxpayer is subject to recapture, the U.S. taxpayer's basis in its dual resident corporation should be restored.

9. RICs and REITs. The Proposed Regulations exclude S corporations from the dual consolidated loss limitations by excluding them from the definition with "domestic corporation." This rule applies even to a foreign unit of an S corporation. The Preamble asks whether similar treatment should be extended to regulated investment companies ("RICs") and real estate investment trusts ("REITs"). We agree that S corporations, RICs and REITs are similar to each other because none of them are effectively subject to corporate income tax and none join in consolidated returns with their shareholders. However, we are concerned about the situation where a RIC or REIT owns a foreign branch or hybrid entity, the losses of the foreign branch or hybrid entity generate an NOL for the RIC or REIT, those losses are also used by another foreign entity, and the RIC or REIT merges into a C corporation that may use the NOL (subject to section 382). Therefore, we would recommend applying the dual consolidated loss rules to RICs and REITs, but applying recapture following a domestic use election only if and to the extent of a foreign use and a section 381 transaction by the RIC or REIT, unless the surviving corporation elected to forego the NOL. If a C corporation acquires NOLs from a RIC or REIT, but at the time of the transaction there had not yet been any foreign use, then the normal recapture rules would apply to the C corporation on a going forward basis.

10. Effective Date. We recommend that when the Proposed Regulations are finalized, taxpayers have the option to apply them retroactively in whole, but not in part.

II. HISTORY OF THE DUAL CONSOLIDATED LOSS PROVISION

The dual consolidated loss provision of Section 1503(d) of the Code, enacted in the Tax Reform Act of 1986 (Public Law 99-514), was one of the first responses of U.S. tax law to the growth of international tax arbitrage and the generation of simultaneous and duplicative tax benefits in two different tax jurisdictions ("double dipping"). The history of the provision and the regulations interpreting it can be divided into three significant events: (i) the enactment of Section 1503(d) in 1986, (ii) the amendment of Section 1503(d) in 1988 to extend it to "separate units of domestic corporations" and (iii) the promulgation of the elective entity classification rules (the "check-the-box" rules) in 1996,[6] which substantially expanded the opportunities for loss duplication.

The regulatory interpretations of the dual consolidated loss provisions began with temporary regulations adopted in September of 1989.[7] The temporary

[6] Reg. § 301.7701-2 and 3, T.D. 8697 (December 18, 1996).
[7] *See,* Treasury Decision 8261 (September 7, 1989) and Treasury Decision 8434 (September 4, 1992, later corrected on October 27, 1992 and March 10, 1993).

regulations were superseded by Current Regulations in 1992. The Current Regulations, adopted five years before the check-the-box rules, could not have anticipated the increase in structuring flexibility created by the check-the-box rules.

A. Context

For clarity, it is useful to place the perceived tax abuse in factual context. Double tax benefit structures in general, such as cross-border equipment leasing transactions relying upon inconsistent foreign tax law interpretations, were not the subject of the dual consolidated loss provision. Instead, the focus of the dual consolidated loss provision was on the dual resident corporations (sometimes referred to herein as "DRCs") the losses of which could be included simultaneously in a U.S. consolidated group and a foreign consolidated group. By isolating expenses in a DRC, without income, it might be possible to use such expenses to reduce income in both the U.S. group and the foreign group simultaneously.

Under the tax laws of the United Kingdom (and Australia), among others, a corporation organized in the United States is treated as a U.K. tax resident if it is managed and controlled from within the U.K. Such a corporation could be a member of a U.S. consolidated group and also be included in a U.K. "group relief" election. If such a dual resident corporation incurred indebtedness to buy a U.S. target corporation, but had no other income in a year, the interest expense incurred by the DRC would be deductible, generally, in calculating the taxable income of the U.S. consolidated group including the target. In the same year, the DRC could surrender the interest expense to other affiliates of its U.K. group to offset U.K. income of the affiliate not subject to U.S. income tax.[8] This second deduction reduces the cost of capital for the UK group in a manner that a domestic acquirer could not replicate.[9]

Similarly, a U.S. consolidated group could organize a U.S. corporation to acquire a corporation in the U.K. or other foreign jurisdiction (sometimes referred to as the "host country"). The U.S. acquiring corporation could incur indebtedness to buy the foreign target company. Like the inbound example above, the acquiring corporation's interest expense would be deductible in calculating the consolidated taxable income of the U.S. consolidated group of which it was a member. At the same time, assuming the U.S. corporation was treated as a resident of the country in which it made the acquisition due to its management location or other factors, it might join in a group relief, fiscal unity, or other consolidation regime with the target corporation. Assuming the DRC had no income items, its interest expense would be available for surrender to the target

[8] The above described double tax benefit may exist even if the DRC receives dividends from the U.S. target. For foreign tax law purposes, these dividends might carry a credit for U.S. taxes paid, a participation exemption or otherwise be excluded from the income of the foreign group allowing the interest benefit to remain available for surrender to other foreign group members.

[9] *See S.Rep. No. 99-313, 1986-3 C.B. Vol.3, 420* (the Senate Finance Committee described this as an example of a targeted abuse). And compare with the domestic reverse hybrid issues addressed later by Reg. § 1.894-1(d)(2), discussed in footnote 16, infra.

company or otherwise reduce the taxable income of affiliates in the host country that are not currently subject to U.S. tax. This second simultaneous use of the interest expense attribute reduces the DRC's cost of capital and may act to encourage it to deploy assets abroad instead of the United States.

B. Statutory Provision

Section 1503(d), as originally enacted, provides that "the dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year". The provision then defines dual consolidated loss to mean "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis." Thus, the entity having a loss must be taxed as resident both in the United States and in another country. Section 1503(d)(2)(B) includes a potential relaxation of the dual consolidated loss limitation: "to the extent provided in regulations, the term 'dual consolidated loss' shall not include any loss which, under the foreign income tax law, does not offset the income of any foreign corporation." Section 1503(d) does not deny the dual resident corporation the ability to use its own loss, either in the year incurred or in later years by a carryover. Rather, it prevents the loss from being shared with a U.S. affiliate if the loss is also available to a foreign affiliate.

The legislative history of the dual consolidated loss provision during the development of the Tax Reform Act of 1986 sheds light on the Congressional intent. The House Bill contained no relevant provision. The Senate Finance Committee report introduced a dual resident provision which would have denied a dual resident corporation the ability to join in a U.S. consolidated income tax return in a year in which in another country it "consolidates with or otherwise transfers tax benefits to a related party all of whose earnings are not currently or eventually subject to U.S. tax."[10] Interestingly, the Senate provision would not have applied to the outbound acquisition example, discussed above. The drafters seemed to have believed that the foreign use of the dual tax benefit would ultimately reduce foreign tax credits recapturing the double tax benefit. In arguing that this provision did not violate U.S. treaty obligations prohibiting discrimination, the Senate Finance Committee articulated clearly its intent as follows:

> "It is the Committee's view that this prohibition of double-dipping is, in fact, necessary to prevent discrimination in favor of foreign-owned businesses and against U.S.-owned businesses in the U.S. economy . . . [T]he Committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S.

[10] *S. Rep. 99-313, 1986-3 C.B. Vol.3, 421.*

> corporate tax through self-help and gain an advantage over U.S. persons who make similar investments." *Id. at 422.*

In the finalization of the Tax Reform Act of 1986, the Conference Committee made a substantial change in the structure of the dual consolidated loss limitation to place it on a more secure footing against treaty discrimination challenges. The Conference Committee stated that the denial of the consolidation privilege was potentially an undesirable remedy for the abuse identified. The Conference Committee felt that a more sensible approach was to prevent the sharing of the DRC's deduction, effectively deferring the deduction until such time as the dual resident corporation has its own income against which to utilize such loss (in the manner of the separate return limitation year restrictions imposed by the consolidated return regulations, hereinafter referred to as the "SRLY limitation"). Presumably, the DRC's future income would also be included in taxable income in both jurisdictions, neutralizing the prior loss for both jurisdictions. "The Conference saw no reason to prohibit application of the consolidated return rules . . . so long as the dual resident corporation's losses do not reduce both the taxable income of a foreign corporation in a foreign country and the U.S. taxable income of some other U.S. corporation."[11]

In furtherance of its changes to make the provision more defensible against treaty discrimination concerns, the Conference Committee extended the application of the dual consolidated loss limitation to U.S. controlled DRC's saying: "This rule expands that of the Senate amendment, which would not have applied when the income of a foreign corporation whose foreign tax the dual resident corporation's loss could reduce was or would be subject to U.S. tax."[12] Thus, the final statute dropped the thinking of the Senate Finance Committee that a double use of loss to reduce foreign tax of a U.S. controlled group would be effectively recaptured through reductions in the foreign tax credits later available to the U.S. corporate parent upon repatriation of foreign profits.

C. Extension to Separate Units

In 1988, important provisions were added to the dual consolidated loss statute which had a significant impact on the scope of the dual consolidated loss limitations and the consistency of its application to inbound and outbound situations ("bilateral parity").

In the Technical and Miscellaneous Revenue Act of 1988, the dual consolidated loss limitation was extended to separate units of domestic corporations. Section 1503(d)(3) provides: "To the extent provided in regulations, any loss of a separate unit of a domestic corporation shall be subject to the limitations of this subsection in the same manner as if such unit were a wholly owned subsidiary of such

[11] *Conference Rep. No. 99-841, 1986-3 C.B. Vol. 4, 657.*
[12] *Id*. At 658.

corporation." This provision was clearly designed to extend the DCL limitation to the foreign branch of a U.S. corporation that, under certain foreign law, might be permitted to surrender its loss to foreign affiliates. The specific example in the Senate Committee's accompanying report describes a foreign branch of a U.S. corporation incurring a foreign loss. The U.S. corporation has foreign subsidiaries with whom the branch in the same country was able to consolidate under foreign law. The Senate Report indicates that the branch will be treated as a domestic corporation with a dual consolidated loss. Therefore, the loss of such branch may not be utilized to offset the income of its U.S. head office (or any other member of the U.S. consolidated group) other than income generated by the branch itself.[13]

This extension of the dual consolidated loss provision to branches and potentially to partnerships was a reasonable expansion of the statute. However, because this provision refers only to a separate unit of a domestic corporation, it does not result in a bilateral extension of the DCL limitation because it was unnecessary. That is, the provision does not apply to a U.S. branch of a foreign corporation, because a foreign-owned U.S. branch with a loss in the United States was not then, and is not now, able to consolidate with U.S. affiliated corporations. Thus, a U.S. unit of a foreign corporation is not subject to the provision.[14] This 1988 change, of course, did not anticipate the check-the-box rules under which a U.S. partnership could elect to be treated as a domestic corporation, and then could share losses with its U.S. and foreign affiliates.

D. Expansion by Check-the-Box

The third important change in U.S. tax law affecting the application of the dual consolidated loss provision arose with the adoption of the check-the-box rules in December of 1996 contained in Regulations §§ 301.7701-2 and 3. While the dual consolidated loss provision had been extended to U.S.-owned separate units, primarily branches, that extension related to natural branches, i.e. unincorporated divisions of a U.S. corporation. Under Regulation § 301.7701-2(a), however, an electing foreign eligible entity wholly-owned by a U.S. corporation is treated as a "sole proprietorship, branch, or division of the owner". Accordingly, the foreign disregarded entity ("hybrid branch") would be a separate unit for purposes of the dual consolidated loss provisions. Similarly, jointly-owned foreign eligible entities checking the box to be treated as transparent are regarded as hybrid partnerships under the check-the-box rules ("hybrid partnerships"). Interests in a hybrid partnership would also seem to be a separate unit under the DCL rules.

Hybrid branches (disregarded entities) and hybrid partnerships changed the environment for the application of the dual consolidated loss rules. Previously, the DCL rules applied only to a limited set of situations: corporations in jurisdictions with

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[13] *S. Rep. No. 100-455, S. Finance Committee Report on the Technical Miscellaneous Act, U.S. Code and Administrative Review, 100th Cong. 2d Sess. Vol. 6 at 4820 (1988).*

[14] See, e.g. Chief Counsel Advice (Sept. 4, 2001), released as PLR 200149023.

residency rules different from the U.S. rules or jurisdictions where natural branches of U.S. corporations could consolidate with foreign corporate affiliates. After the check-the-box rules, the application of the DCL rules expanded greatly. Foreign law will normally treat the U.S. controlled hybrid branch or U.S. controlled hybrid partnership as a corporation fully subject to tax in the host country on a residence basis. Accordingly, any foreign jurisdiction with a check-the-box eligible entity could host a dual resident corporation. Hybrid branches and hybrid partnerships were and are used frequently by U.S. multinationals acquiring companies abroad as a means of allowing the U.S. acquiring entity to improve its foreign tax credit limitation.[15] Where a U.S. multinational incurred interest in a CFC, its gross foreign source income for its foreign tax credit limitation would be limited to the CFC's post-debt-service dividends. But if the CFC were financed by hybrid branch debt, gross foreign source income is the pre-debt-service income. And in that situation the hybrid branch's interest expense is allocated with the rest of the consolidated group's interest expense between U.S. and foreign source income. Where foreign assets are a small portion of world wide assets, this structure expands the U.S. multinational's foreign tax credit limitation.[16]

The check-the-box rules also introduced domestic reverse hybrids (e.g., a U.S. partnership treated as a corporation for U.S. tax purposes) through which a U.S. separate unit owned by a foreign corporation could be used to double dip U.S. interest expense. However, the use of a domestic reverse hybrid is not subject to the dual consolidated loss rules because the domestic reverse hybrid is not "a separate unit of a domestic corporation" to which Section 1503(d) was extended in 1988.[17]

III. CURRENT REGULATIONS

The Current Regulations contained in Regulation § 1.1503-2 were adopted in 1992[18] to implement the brief statutory provisions described above. A short summary of their rules is necessary to show the changes proposed by the new regulations.

A. Key Definitions

The Current Regulations impose the dual consolidated loss limitation in subsection (b) saying: "a dual consolidated loss of a dual resident corporation cannot offset the taxable income of any domestic affiliate . . . ." Subsection (d) further specifies that the U.S. group which includes a DRC "shall compute its consolidated taxable income

[15] See Hardy, *Tax Notes Today (August 2, 1999).*
[16] Compare Section 904(a) with Reg. § 1.861-9T(a), (e) and (f). *See Reg. § 1.701-2(f) example 3* (treating the use of partnerships to improve U.S. foreign tax credit utilization as an appropriate use of partnerships); and see *Section 401(a)* under the American Jobs Creation Act of 2004 (enacting global interest allocation for years after 2008).
[17] *See Reg. § 1.894-1(d)(2),* adopted by *T.D. 8999, 2002-28 I.R.B. 78;* and see *N.Y.S.B.A. Tax Section Rep. No. 1004, Tax Notes Today (January 15, 2002)* (suggesting domestic reverse hybrid double dip opportunities should be addressed by the dual consolidated loss rules).
[18] T.D. 8434, 1992-2 C.B.240.

without taking into account the items of income, loss, or deduction taken into account in computing the dual consolidated loss." The DCL may be carried over or back by the DRC, and be treated as a loss incurred in a separate return limitation year subject to the limitations of Reg. § 1.1502-21(c) (regarding SRLY limitation). So, if a DRC has a DCL of $1.00 resulting from $1,000,000 of gross income and $1,000,001 of deductions, all of its items are subject to a SRLY limitation and none flow into the consolidated return of its U.S. parent.[19]

As implicit in the statute, the Current Regulations define dual consolidated loss to mean generally a "net operating loss (as defined in Section 172(c) of the regulations thereunder) of a domestic corporation incurred in a year in which the corporation is a dual resident corporation".[20] And subsection (d) states that capital losses are specifically not taken into account in calculating a dual consolidated loss.

The Current Regulations set forth rules to determine how the DCL rules are applied to separate units of a corporation. A "separate unit of a domestic corporation . . . shall be treated as a dual resident corporation." If one separate unit is owned by another, the rules treat the upper tier separate unit as a subsidiary of a domestic corporation and the lower tier separate unit as a lower tier subsidiary.[21] "'Separate Unit' shall mean any of the following: a foreign branch, as defined in § 1.367(a)-6T(g) . . . an interest in a partnership . . . or an interest in a trust." "'Separate Unit' includes an interest in an entity that is not taxable as an association for U.S. income tax purposes but is subject to income tax in a foreign country as a corporation . . ." (i.e. a hybrid entity separate unit).[22]

The foregoing entity definitions are supplemented by a limited branch combination rule. It states: "If two or more foreign branches located in the same foreign country are owned by a single domestic corporation and the losses of each branch are made available to offset the income of the other branches under tax laws of the foreign country . . . then the branches shall be treated as one separate unit."[23] The Internal Revenue Service is known to interpret the rule as not being available to hybrid branches (i.e. disregarded entities) and not being available to two natural branches where one owns the other (for natural branches, stacked ownership may be legally indistinguishable from common ownership by the domestic corporation). By limiting the combinations of branch activities, the Current Regulations make it more likely that a unit will be isolated for determining the existence of a DCL and the imposition of the SRLY limitation.

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[19] Subsection (f) of the Current Regulations states that the consolidated group including a dual resident unit calculates its foreign tax credit limitation without taking into account the items of the dual resident unit. As a result, imposing a SRLY limitation on all items of a DRC may significantly change the foreign tax credit limitation for a small amount of loss.

[20] *See Reg. § 1.1503-2(c)(5).* While the adoption of the U.S. rules for calculating the existence of loss seems to be the correct standard, it does result in the potential for a restricted DCL where no loss actually exists under foreign to create a duplicate benefit.

[21] See Reg. § 1.1503-2(b)(2)

[22] Reg. § 1.1503-2(c)(3) and (4).

[23] Reg. § 1.1503-2(c)(4)(ii).

B. <u>Accounting and Calculation Rules</u>

Subsection (d) of the Current Regulations also provides the accounting rules for dual consolidated losses. This provision generally utilizes the consolidated return accounting principles for dual consolidated corporations and for dual resident units. Thus dividends from lower tiers are excluded from income.

Subsection (d) also contains an important provision for reversing the normal stock basis adjustment rule of consolidated subsidiaries for dual consolidated losses of a DRC. The general consolidated return rule is that a subsidiary corporation's losses do not reduce its parent's basis in the loss corporation's stock until the losses are absorbed.[24] The Current Regulations provide that a negative adjustment for DCLs shall be made whether or not the DCL is absorbed and no further negative basis adjustment occurs in a carryover year when the DCL is absorbed. Finally, the regulation states that no positive basis adjustment is made if a dual consolidated loss for which a domestic use election is made is later recaptured.[25] Thus, the dual consolidated loss reduces stock basis permanently when incurred without further adjustment. This reversal of the general consolidated return rules avoids the conversion of a dual consolidated loss into a potential capital loss on the sale of the stock of the DRC.

C. <u>Domestic Use Election</u>

From its very first published guidance on dual consolidated losses,[26] the Treasury has exercised its statutory authority to permit taxpayers to use dual consolidated losses to offset income of their U.S. affiliates where they elect not to use such losses to reduce the income of a foreign person. Regulation § 1.1503-2(g)(2) of the Current Regulations contains this domestic use election.[27] It provides that a dual resident corporation with a dual consolidated loss may file an election to use the loss only against the income of a U.S. affiliate provided it enters into a 15 year annual certification agreement to notify the IRS if the loss is subsequently used to offset the income of a foreign person. For this purpose, subsection (c) of the Current Regulations defines "use of loss" by stating that a loss is deemed to offset income "in the year it is included in the computation of the consolidated taxable income . . . ." Similarly, the loss is treated as offsetting income of another person under foreign law "in the year made available" for

[24] *Reg. § 1.1502-32(b)(3).*
[25] *Reg. § 1.1503-2(d)(3).*
[26] Temporary Regulations § 1.1503-2A, T.D. 8261, 1989-2 C.B. 220 (1989).
[27] Reg. § 1.1503-2(g)(1) also provides that dual consolidation loss limitation shall not apply to losses available to the U.S. group where the taxpayer has made an election "pursuant to an agreement entered into between the United States and the foreign country that puts into place an elective procedure through which losses offset income in only one country." However, no such bilateral agreement has been adopted.

use (regardless of whether sufficient income exists to benefit from the loss) unless the foreign use requires an election which has not been made.[28]

The dual consolidated loss utilized by virtue of a domestic use election must be recaptured in full if "any portion of the loss" is later utilized or treated as utilized to offset the income of a foreign person. An extensive set of rules accompany this election procedure including recapture triggering events and rebuttal to recapture amounts. Due to the ambiguities inherent in the Current Regulations, this election procedure has been frequently invoked. The frequency of use of the election makes the scope and clarity of the recapture provisions important, since any later foreign use results in full DCL recapture.

D. Mirror Rule

A significant limitation to the domestic use election described above is contained in the "mirror rule". In the temporary regulations adopted in 1989, the Treasury provided the domestic use or (g)(2) election, described above, implementing the statutory authority of Section 1503(d)(2)(B). That subsection provides "to the extent provided in regulations, the term 'dual consolidated loss' shall not include any loss which, under the foreign income tax law, does not offset the income of a foreign corporation." Under the mirror rule, however, if a foreign loss cannot be used in a foreign jurisdiction because of foreign tax law restrictions denying the use of dual consolidated losses (*i.e.* legislation which 'mirrors' the U.S. legislation), such loss shall be deemed to have been used to offset the income of a foreign person.[29] As a result, a loss subject to mirror legislation is ineligible for a domestic use election and it can only be used against the DRC's own future income.

This mirror rule was thought to be necessary to prevent foreign jurisdictions from adopting their own dual resident legislation to capture tax revenue at the expense of the United States. The foreign jurisdiction could disallow the use of dual consolidated losses in its country and thereby permit the dual resident corporations to utilize the loss in the United States under the domestic use election because the DRC could certify that the loss could not be used under foreign law to offset the income of a foreign person. Indeed, the U.K. did adopt such legislation shortly after the enactment of the Tax Reform Act of 1986. The General Explanation of the Tax Reform Act of 1986 (the "General Explanation" or the "Blue Book") written by the Joint Committee staff after the enactment of the 1986 Act, specifically referred to that subsequent U.K. enactment. It stated that Congress did not intend the domestic use election to permit foreign jurisdictions to claim the revenue benefits of DCL disallowance by use of mirror legislation.[30] The resulting forfeiture is a harsh result, even if the taxpayer knowingly placed itself in dual resident structure. The mirror rule seems to have been perceived as

[28] Reg. § 1.1503-2(c)(15)(ii). Paragraph (iii) contains a taxpayer favorable presumption that a separate unit's losses shall first offset income of another separate unit owned by the same U.S. consolidated group.
[29] Reg. § 1.1503-2(c)(15)(iv)).
[30] *General Explanation at 1065.*

leverage to cause the U.S. and the foreign country counterpart to enter into a protocol or other procedure contemplated by Regulation § 1.1503-(2)(g)(1) to allow the taxpayer's claim of loss only in the more appropriate jurisdiction. However, no diplomatic negotiation in treaties, between competent authorities or otherwise, has yet occurred to implement such a procedure.

This mirror legislation rule was specifically litigated in British Car Auctions Inc. v. U.S.[31] In that case, a U.S. corporation with losses was also considered resident in the U.K., a jurisdiction having mirror legislation. The taxpayer claimed a refund for using the losses against the income of other members of the taxpayer's U.S. consolidated return group. The IRS disallowed that claim. The taxpayer filed a complaint seeking to have the mirror legislation regulation ruled invalid. The Court cited the General Explanation in stating: "Thus, Congress, albeit subsequent to the passage of section 1503(d), noted that it did not want the exceptions to . . . § 1503(d) to result in the United States fisc losing revenue to a foreign tax jurisdiction as a result of 'mirror legislation.'" The court found the regulation to be a valid regulation and a reasonable limitation on the exercise of the IRS authority to grant a domestic use election.

IV. PROPOSED REGULATIONS

A. Purposes and Constraints

The preamble to the Proposed Regulations[32] confirms that the policy of the dual consolidated loss rules is the reduction in international double dipping through dual residency. The principal objective of the drafters of the Proposed DCL Regulations is to eliminate over-inclusions and under-inclusions of the Current Regulations. The curtailment of over-inclusion is furthered by the Proposed Regulations refining the definition of "separate units" to specifically deal with branches, disregarded entities and partnerships as required by the expansion of those entities following the promulgation of the check-the-box regulations. Beyond that, the new regulations limit the SRLY'd attributes arising from a DCL to a proportionate share of individual attributes giving rise to the disallowed loss. And the drafters clearly sought to provide more clarity and precision to the area of the domestic use election. Last, the Proposed DCL Regulations would simplify the administrative practice in this area by, among other things, reducing the certification period to 7 years for the domestic use election, replacing Section 9100 relief with a reasonable cause exception, and providing revenue procedure authority for rebutting a domestic use election recapture. We think the regulations do a commendable job on each of these points, addressing these important policy goals of clarity and precision.

[31] *See 35 Fed. Cl. 123 (1996), aff'd per curiam 116 F.3d 1497 (Fed.Cir. 1997).*
[32] The Preamble to the Proposed Regulation (hereinafter "the Preamble").

In revising the Current Regulations, the Treasury entertained other significant policy and administrative constraints affecting the mechanics of the regulations implementing Section 1503(d). Among these is the question of how much foreign law to utilize in attempting to identify dual resident double dip opportunities, e.g., foreign consolidation rules only vs. foreign definition of tax base. The impact of foreign tax law is an integral component of identifying and limiting double dip opportunities. In general, the Proposed DCL Regulations, continue to determine the existence of a loss under U.S. principles (as defined in Section 172(c)). However, as discussed below, the Treasury has looked to the differences in foreign law's tax treatment of natural partnership versus hybrid partnership to exclude natural partnerships from the definition of separate unit. Similarly, foreign law differences caused the Treasury to propose to attribute head office interest expense to natural branches but not to hybrid branches.

The Proposed DCL Regulations largely retain the operating rules and accounting rules from the prior regulations. Indeed, the major new drafting is comprised of 52 numbered examples contained in Proposed Regulation § 1.1503(d)-5. We think that consistency and predictability are advanced by clarifying the Current Regulations.

B. Detailed Rules

In the words of John Merrick, Special Chief Counsel to the Associate Chief Counsel (International), the Proposed DCL Regulations limit double-dip transactions by (i) first identifying a loss of an entity that is dual resident, and then (ii) determining whether such loss is available to offset the income of a person not subject to U.S. tax ("Foreign Use").[33] These two conclusions establish, in the Treasury's view, that an impermissible double-dip occurs. The proposed regulations are broken into five sections:

- Basic Operating Rules
- Definitions
- Special Accounting Rules
- Exceptions to Domestic Use; and
- Interpretive Examples

[33] John Merrick, Special Chief Counsel to the Associate Chief Counsel (International), Internal Revenue Service, Remarks to the *International Tax Institute of New York, June 21, 2005*.

1. Basic Operating Rules

The basic operating rules of the Proposed Regulations are deceptively simple: Proposed Reg. § 1.1503(d)-2(b) denies the loss with the language "the domestic use of a dual consolidated loss is not permitted". As under current law, the dual consolidated loss of a DRC remains available to offset its own income. The prohibited "domestic use" is making the loss available to offset the taxable income of a domestic affiliate.[34] Like the Current Regulations, the Proposed Regulations DCL restriction is imposed through a mechanic which subjects the DCL to the limitation of § 1.1502-21(c) regarding the separate return limitation year restrictions ("SRLY").[35] To protect the basic limitation, as under the Current Regulations, Proposed Reg. §1.1503(d)-2(c) "eliminates" the dual consolidated loss of a DRC in the event of 381(a) transaction (e.g. or section 332 liquidation) other than in respect of an (F) reorganization into a domestic corporation and 381(a) carryovers to a DRC in the same country.

A very significant curtailment in the application of the DCL limitation is proposed by the reduction of the attributes which are subjected to the SRLY limitation to a pro rata portion of all expense items. Under Current Regulations, a separate unit having a DCL was subjected to SRLY limitation on all of its items and such items would not be released to the U.S. affiliates of the DRC until the separate unit had income sufficient to overcome the prior loss. Thus, under the Current Regulation, a DRC with $1,000,001 of expense and $1,000,000 of income has only $1.00 loss but all of its items are subject to the SRLY limitation.

Subsection (c) of the Proposed Regulation §1.1503(d)-3 provides for a much more limited effect of a dual consolidated loss on the domestic affiliate. The rule states that the consolidated group of which the DRC is a member shall compute consolidated taxable income by taking into account the DRC's items "other than those items of deduction and loss that compose the dual resident corporation's dual consolidated loss. The DCL shall be treated as composed of a *pro rata* portion of each item of deduction and loss of the DRC taken into account in calculating the dual consolidated loss." Similarly in respect of separate units, the SRLY'd DCL is treated as composed of a *pro rata* portion of the separate unit's deduction and loss items and only that portion of those items are restricted. So, under the Proposed Regulation, a DRC with $1,000,001 of expense and $1,000,000 of income would compute its consolidated taxable income using all of the DRC's income items and all but $1.00 of the DRC's loss items.

We think this change is a significant improvement in the operation of the rules, because it prevents only the actual amount of the loss and not all the other items (*e.g.,* foreign source income and allocable interest expense) from flowing into the U.S. return of the owner of a DRC.

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[34] *See Prop. Reg. § 1.1503(d)-1(b)(13).*
[35] *See Prop. Reg. § 1.1503(d)-3(c)(3)*

2. Definitions

While the DCL definitions of the Proposed Regulations are generally consistent with the Current Regulations, significant divergence exists in the area of entity classification.

a. Dual Consolidated Loss

The term ”dual consolidated loss”, as under Current Regulations, means a loss as calculated under Section 172(c) of the Code without regard to the existence of a loss in calculating the foreign tax base. In the case of a separate unit, the dual consolidated loss shall be the net loss otherwise attributable to the unit. And the Proposed Regulations exclude capital losses from dual consolidated loss, just as the Current Regulations do.

b. Dual Resident Corporation

The Proposed Regulations incorporate the existing definition of dual resident corporation, *i.e*. a U.S. corporation subject to residence based taxation in another jurisdiction. Under the Current Regulations, S corporations are excluded from the definition of dual resident. Because an S corporation cannot generally consolidate (other than with qualified subchapter S subsidiaries which are actually disregarded) they are essentially stand alone U.S. corporations, not able to share a loss with a domestic affiliate. Some remained concerned that branches of S corporations might be affected by the DCL rules. The Proposed Regulations resolve this issue by stating that, for purposes of Section 1503(d), domestic corporation does not include an S corporation.

As the DCL regulations exclude “S” corporations from their application, they might have granted a similar exclusion to regulated investment companies under Section 851 of the Code (“RICs”) and to real estate investment trusts under Section 856 of the Code (“REITs”). We believe that RICs and REITs are, in general, entities that are not generally subject to an entity level tax and cannot consolidate (other than with certain wholly-owned subsidiaries). In this they resemble S corporations. And because RICs and REITs are not permitted to be engaged in true business activity, they are less likely to be incurring losses. However, if a RIC or REIT merges into a subchapter C corporation and carries over its losses pursuant to Section 381, subject to Section 382’s limitations, it could become a vehicle for dual resident double dipping.

RECOMMENDATION: Accordingly, RICs and REITs should be insulated from the normal operation of the DCL rules in a special manner. Therefore, we would recommend applying the dual consolidated loss rules to RICs and REITs, but applying recapture following a domestic use election only if and to the extent of a foreign use and a section 381 transaction by the RIC or REIT, unless the surviving corporation elected to forego the NOL. If a C corporation acquires NOLs from a RIC or REIT, but

at the time of the transaction there had not yet been any foreign use, then the normal recapture rules would apply to the C corporation on a going forward basis.

c. Separate Units

The Proposed Regulations define "separate unit" as a foreign branch as defined under Regulation § 1.367(a)-6T(g) or an interest in a hybrid entity.[36] The Proposed Regulations define hybrid entity as an entity that is not taxable as a corporation for U.S. purposes but is taxable as a corporation under foreign law (or taxable at the entity level). A foreign reverse hybrid will be treated as a foreign corporation for these purposes. A domestic reverse hybrid (a U.S. entity treated as a corporation for U.S. purposes but transparent for foreign purposes) is not treated as a hybrid.

The Current Regulations have consistently reserved on the treatment of an interest in a partnership.[37] The Proposed Regulations engage this issue. Natural partnerships existing under foreign or U.S. law are believed not to be the type of entity easily utilized for double-dip purposes. Accordingly, such natural partnerships themselves, and the interests of the partners in such natural partnerships, are excluded from the definition of separate units. The items of natural partnerships are allocated to their partners under the normal rules. However, a domestic partner's interest in the foreign branch of such a partnership is a separate unit.[38]

d. Separate Unit Combination

Proposed Regulation § 1.1503(d)-1(b)(4)(ii) substantially liberalizes the separate unit combination rule from the Current Regulations. In the new formulation, two or more separate units "owned directly or indirectly" by a single domestic corporation, operating in the same foreign country whose laws allow the losses of each unit to offset the other's income, may be combined for purposes of applying the DCL rules. This rule would eliminate two risks under the Current Regulations: (i) that brother/sister branches could be combined but not parent subsidiary branches and (ii) that branch combination was available to natural branches but may not have been applicable to similarly situated disregarded entities. The regulations also provide that indirect ownership includes indirect ownership through U.S. entities classified as partnerships or grantor trusts, foreign or domestic.

We think this new combination rule is very sensible. We believe that the Current Regulations could be construed in the same manner notwithstanding the assertion

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[36] For purposes of clarity, it might be useful to consider whether a foreign branch or a foreign hybrid entity which is not transacting business as required under Regulation § 1.367(a)-6T(g), such as a passive holding company or an intermediate finance company used solely to obtain acquisition financing, is less than a trade or business under Section 367 and should not be a separate unit under the DCL definitions. See *PLR 200221018 (Feb. 13, 2002).*

[37] See *Reg. § 1.1503-2(c)(5)(iii).*

[38] See Prop. Reg. § 1.1503(d)-5(c) *(Example 14).*

to the contrary in the Preamble. The Current Regulations provide that "separate unit" includes hybrid units and that separate units are either branches or interests in a trust or partnership. Branches are eligible for the separate unit combination rule.

e. Affiliated Unit Combination

The Preamble goes further in asking whether two otherwise combinable separate units owned by two different domestic corporations in the same U.S. consolidated group ought to be able to utilize the separate unit combination rule. If two branches in the same foreign jurisdiction are also members of the same U.S. consolidated group, branch combination adds only what the U.S. group could have achieved through restructuring. We believe that separate unit combination relieves inadvertent and unnecessary applications of the DCL rules. We believe that an apportionment method of allocating a SRLY limitation among the two owning members would be an acceptable mechanic for implementing unit combination in such circumstances.

RECOMMENDATION: Accordingly, we recommend that two separate units, otherwise combinable, owned by different members of the same consolidated group be eligible for combination. We recommend that any SRLY limitation imposed upon such a combined unit could be allocated between the two owning members in proportion to their non combined units share of the of the DCL items.

f. Bilateral Application of Separate Unit Rule

In 1988 Congress added the separate unit rule to section 1503(d), providing that a "separate unit of a domestic corporation" shall be subject to the DCL limitation. This expansion meant that a foreign branch of a U.S. corporation was treated as a dual resident corporation. If the foreign branch had losses that could be shared with its affiliated foreign subsidiaries, its loss could not be shared with its U.S. parent. As written, this statutory change is not applied to a separate unit of foreign corporation, causing the DCL limitations to be imposed more restrictively on U.S. corporations investing abroad than on foreign corporations investing in the United States.

It appears obvious that Congress limited application of the separate unit rule in this way, simply because a U.S. branch owned by a foreign corporation could not consolidate with its U.S. subsidiary corporations. See Section 1504(b). Thus, the inbound application of the rule was not meaningful and did not justify more complex drafting. Those assumptions, rational as they may have been in 1988, were overtaken by the adoption of the check-the-box rules. Under the check-the-box, a foreign owned hybrid branch or hybrid partnership, organized as an entity, (for example a Delaware general partnership owned by a foreign corporation) can elect to be treated as a U.S. corporation eligible to join a U.S. consolidated group. Such a hybrid branch or hybrid

partnership may well be viewed as a partnership for foreign tax law purposes, the losses of which flow through to the foreign partners.[39]

We believe the Congress deliberately structured the DCL rules to have comparable effect on inbound and outbound structures. Read in this light, we think Congress's use of the phrase "separate unit of a domestic corporation" should be informed by its original intent as now applied to the post check-the-box environment.

RECOMMENDATION: We think that Treasury should adopt regulations that extend the DCL limitation to domestic separate units or reverse hybrids owned by a foreign corporations. We find sufficient authority for this change in the general interpretative power of the Treasury under Section 1503(d) as well as its authority under the check-the-box rules. Prospectively, a rule could be promulgated by stating that a check-the-box election for a domestic reverse hybrid will be treated as a consent to the application of a separate unit rule under Section 1503(d). If Treasury believes that it would lack the authority to issue such a regulation because of the statutory language, we suggest the Treasury consider a legislative change to delete "of a domestic corporation" from the separate unit language of section 1503(d)(3).

g. <u>Domestic and Foreign Use</u>

Since foreign use precludes a domestic use election, or triggers a recapture of previously claimed DCLs under a domestic use election, the foreign use definition will bear much traffic. The Proposed Regulations define "domestic use" to occur when the DCL is made available to offset income of a domestic affiliate of the dual resident corporation or separate unit in the year the loss is recognized and regardless of whether the loss actually offsets income. Foreign use is deemed to occur "when any portion of a loss . . . taken into account in computing the dual consolidated loss 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 and that is considered under U.S. tax principles to be an item of . . . a foreign corporation. . . or a direct or indirect owner of an interest in a hybrid entity [that] is not a separate unit." Thus, a tension is created in that the determination of tax base applies U.S. principles, but the determination of availability (ability to consolidate) applies foreign law. No foreign use occurs where a foreign law election is required for the loss to be made available and the election has not been made.[40]

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[39] <u>See</u> *N.Y.S.B.A. Tax Section Rep. No. 1004, footnote 16, supra.* Extending the dual consolidated loss limitation to domestic reverse hybrids was suggested by this Section to have been a more appropriate solution than the regulations promulgated at *Reg. § 1.894-1(d)(2).* And see T. D. 8999, (June 12, 2002) acknowledging that domestic reverse hybrid double dip opportunities might be an appropriate subject for the re-examination of the dual consolidated loss rules.

[40] <u>See</u> *Prop. Reg. §1.1503(d)-5 (Example 7).*

3. Accounting Rules

The accounting rules of the Proposed Regulations largely follow the Current Regulations, applying consolidated return rules and treating separate units as separate domestic corporations in that consolidated return.[41] Two important changes are added: the clarification of disregarded items and the refinement of the "otherwise attributable" standard.

a. Disregarded Items

With respect to disregarded items of separate units, the accounting rules of the Proposed Regulations promulgate the manner in which the IRS ruling staff previously interpreted such regulations. The regulation states that treating the separate unit as a domestic corporation "shall not cause items of income, gain, deduction and loss that are otherwise disregarded for U.S. tax purposes to be regarded for purposes of calculating the dual consolidated loss".[42] Thus, interest expense incurred by a branch on a loan from its head office will be disregarded in calculating its DCL just as the loan is disregarded for tax purposes, generally. As we pointed out in Section I.A.2., this rule may permit U.S. taxpayers to achieve results that are similar to the results targeted by the dual consolidated loss rules without implicating those rules. Another issue relates to how interest income from a lower tier unit is treated in the hands of an upper tier unit. See Section 3.c below. Further, the provision states that separate units shall calculate their DCL separately and that an item of income or deduction shall not be attributable to more than one separate unit.

b. Otherwise Attributable Expenses

The Proposed Regulations follow current law in stating that a separate unit is treated as a domestic corporation with such income as is "otherwise attributable to" the unit.[43] The concept of otherwise attributable is troublesome inasmuch as it had no defined meaning under the Current Regulations and no precise meaning under partnership, subpart (f), or consolidated return principles. The word "attributable" most frequently has meaning in the context in interpretation of U.S. tax treaties where profit and expense attribution to a permanent establishment is a significant issue. In Section 864(c)(4)(B) (regarding "attributable to an office") and Section 865(e), "attributable" means material participation in the event and not simply an apportionment of costs.

The separate unit accounting rules of the Proposed Regulations apply differently to branches than to hybrid entities. In respect of natural branches, the branch

[41] This regulation specifically calls for separate units to calculate their loss using U.S. dollars which presumably is a determination not to allow the separate unit to use functional currency under the Section 987 rules.
[42] *Prop. Reg. § 1.1503(d)-3(b)(2)(i).*
[43] *Prop. Reg. § 1.1503(d)-3(b)(2).*

separate unit is required to determine its loss using Section 864(c)(2) principles (the business use test and material factor test) and to attribute head office interest expense under Regulation §1.882-5 principles.[44] By contrast, the hybrid entity separate unit and the disregarded entity separate unit calculate their interest expense utilizing Section 988 principles reflecting the books and records of the separate unit.[45] This difference will clearly result in natural branches having substantially greater likelihood of DCL treatment than hybrid partnerships and disregarded entities. The Treasury explanation for this inconsistency is that foreign law is likely to attribute head office interest to a natural branch but not to an entity which foreign law regards as a separate corporate taxpayer. True as that observation may be, the distinction creates a fundamental inconsistency between disregarded entities and natural branches not intended in the check-the-box rules.[46] Moreover, this will encourage foreign branches to reorganize as disregarded entities unless, like branches of banks and other financial institutions, they are prevented from doing so by regulatory requirements. Accordingly, the rules appear to have reached a tenuous conclusion which will impose significantly different restrictions on otherwise similarly situated taxpayers.

RECOMMENDATION: We recommend that the Proposed Regulations be changed to attribute head office interest expense to natural branches and to hybrid entities and partnerships if and to the extent that foreign law attributes head office interest expense. Taxpayers would be able to avoid head office interest expense attribution by demonstrating to the satisfaction of the Commissioner that foreign law did not attribute the interest expense to the natural branch or hybrid entity.

c. Otherwise Attributable Income

These Proposed Regulations also speak to the meaning of otherwise attributable in the context of income items flowing through natural and hybrid partnerships, grantor trusts, and disregarded entities. Generally, the Proposed Regulations take the position that items flow up through partnership, grantor trusts and hybrids under the normal allocation rules.[47] Items flowing from CFC's through hybrids are more complex. The Proposed Regulations clarify that where a U.S. person owns a CFC through a separate unit, a subpart f inclusion from the CFC is treated as a dividend to the separate unit to the same extent that an actual dividend would be.[48] We think it is sensible for subpart f income and Section 78 income to be reflected as income of the separate unit, particularly when the cash actually moves up the ownership chain.

A particularly difficult set of issues arise where income flows through tiers of separate units. Specifically, in example 29, the Proposed Regulations contemplate a U.S. corporation that owns a foreign disregarded entity ("DE 1") with a $75 loss. DE 1

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[44] *Prop. Reg. § 1.1503(d)-3(b)(2)ii).*
[45] *Prop. Reg. § 1.1503(d)-3(b)(2)(iii).*
[46] Compare *Reg. § 301.7701-2(a)* (stating that disregarded entity is treated in the same manner as a branch).
[47] See *Prop. Reg. § 1.1503(d)-3(b)(iii)-(vi).*
[48] *Prop. Reg. § 1.1503(d)-3(b)(2)(vii)(D).*

in turn owns DE 3, a disregarded entity in a different country (ineligible for branch combination) which owns the stock of a controlled foreign corporation ("CFC"). The CFC distributes $50 of earnings as a dividend which amount carries $25 of Section 78 income. The example concludes that DE 3 has $75 of income for these purposes. DE 3 then distributes its $50 of cash income to DE 1. This distribution is ignored entirely because, we believe, the distribution is regarded as a branch remittance or an intercorporate dividend, excludable under consolidated return regulations. So DE 1 is considered to have a loss.[49]

Under the accounting rules for calculating dual consolidated loss, separate units are treated as domestic corporations and their otherwise attributable income is calculated under consolidated return principles. As a result, when one separate unit owns a second separate unit, lower tier unit distributions are excluded from the recipient's income as consolidated return excluded dividends. A similar exclusion results from the disregarded item provisions in the Proposed Regulations § 1.1503(d)-3(b). That states that disregarded items do not become regarded in the hands of a separate unit. The rule also states that items will only be attributable to one separate unit. In situations where the upper tier separate unit is utilizing lower tier separate unit cash distributions to service interest on indebtedness, one could argue that these exclusion provisions create a dual consolidated loss that appears inappropriate. In such an instance, the entity generating the loss will have received economic income from the lower tiers which services the interest expense. The U.S. owner has received income and expense through the separate units in equal amounts. The dual consolidated loss resulting from the income exclusion cannot be reversed without the separate unit incurring additional income of an equal amount. Assuming the entities are not eligible for separate unit combination, the dual consolidated loss exists and cannot be reversed. If a domestic use election has been filed in respect of this situation, a recapture event will occur if the separate units are incorporated or sold to unrelated persons.

When the Current Regulations were in proposed form, dividend exclusion of the consolidated return accounting principles was originally reversed allowing separate unit dividends to be counted as offsetting expenses of the DRC. Based upon limited comments from practitioners, this special rule was eliminated and the general consolidated return dividend exclusion was substituted. With the advent of check-the-box, disregarded items may produce a similar result. Example (29) appears to treat a branch remittance as either a disregarded item or a duplicated income item that may not be attributed to more than one separate unit. But that remittance could be viewed as not counted because the head office received income previously when its branch did. Thought of this was, branch remittances are neither disregarded items nor duplicated items.

RECOMMENDATION: We recommend either that the Proposed Regulations treat each unit as a separate U.S. corporation (and not exclude the distributions from a lower-tier separate unit), or else permit the taxpayer to demonstrate

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[49] *Prop. Reg. § 1.1503(d)-4 example 29.*

to the satisfaction of the IRS that the distribution received by a separate unit from a lower-tier separate unit is taxable under foreign tax law (and is not excluded under a participation exemption or otherwise).

d. Basis Adjustment

Under the Proposed Regulation, as under the Current Regulations, the basis adjustment rule of the consolidated return regulations - that NOLs do not produce a stock basis adjustment under the Reg. §1.1502-32(b) rules until the loss is absorbed - are overridden so that the restricted DCL cannot be converted into a stock loss.

Thus, the SRLY restricted DCL reduces the basis in stock of the U.S. owner of a dual resident corporation when the DCL is incurred. And no further negative adjustment occurs when the DCL is absorbed. If the DCL is used and later recaptured as ordinary income due to a domestic use election recapture event, "no positive adjustment under §1.1502-32(b)(2) occurs". The DCL reduces stock basis permanently when first incurred. In addition, a special rule is included for the basis adjustments to hybrid entities that are partnerships, which carries forth the same principle, *i.e.*, dual consolidated loss limited by SRLY nonetheless reduces the partner's outside basis.

The Proposed Regulation overrides the consolidated return rules to require a permanent downward adjustment of stock basis of a DRC with a SRLY'd DCL in order to prevent a DCL from being converted into a stock loss.[50] We think the rule requiring a permanent downward stock basis adjustment for DCLs is inappropriate if the taxpayer is required to recapture the DCL.

RECOMMENDATION: Accordingly we recommend that the stock basis of a DRC or the basis in the interest on a hybrid partnership that is reduced by the amount of a DCL be restored in the amount of any recapture income later triggered.

e. Foreign Tax Credit.

The Proposed Regulations continue the Current Regulation's rule regarding computation of the foreign tax credit limitation. Subsection (e) provides that the dual resident corporation or separate unit shall compute its foreign tax credit limitation without regard to the items constituting the dual consolidated loss. However, as seen, the Proposed Regulations reduce the SRLY'd items to a pro rata share of all expense items to the extent of the loss. Thus, under the Proposed Regulations, a DRC with $80 of foreign source income and $100 of expense would have a $20 DCL and the SRLY limitations would only apply to $20 of loss. All of the foreign source gross income will still flow into the U.S. return of the owner. Also, foreign interest expense of the DRC to the extent exceeding the SRLY'd amount will flow into the U.S. return. We think this change is an excellent change from Current Regulations.

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[50] *See Reg. §1.1503-2(d)(1)* and *Prop. Reg. § 1.1503(d)-3(b)(1).*

The Proposed Regulations, like the Current Regulations, do not specifically state that the foreign tax credit itself of a dual resident corporation or separate unit is subject to the SRLY limitations in the event of a dual consolidated loss. Some argue that such an application should be the rule because foreign tax credit is derived from foreign tax expense, an item which would be subject to the DCL limitation absent the taxpayer's election to utilize the credit. If the foreign tax credit were not subject to the DCL limitations, the foreign tax credit would flow into the U.S. return of the DRC's owner (and commence its carryforward life) while the foreign source income that generated the credit was SRLY'd, substantially increasing the risk of lost credit through carryover limitations. The IRS is believed to have interpreted the rules differently: that foreign tax credit is not an item of loss or expense subject to the SRLY limitations by the existence of a dual consolidated loss. Instead, the foreign tax credit flows directly to its U.S. corporate recipient under the credit rules with such foreign tax credit limitation as that taxpayer otherwise establishes without regard to the SRLY'd items of the DRC. The Proposed Regulations will allow foreign source gross income to flow into the tax return of the U.S. affiliate from a DCL unit and that will make crediting of foreign taxes much more likely even if the foreign tax credit is not SRLY'd with the other items. Nonetheless, it would be useful for the Treasury to state specifically that the foreign tax credit is, or is not, SRLY'd.

4. Domestic Use Election/Mirror Rule

Under the Current Regulations, practitioners pay as much attention to the domestic use election as to all of the rest of the regulations. The IRS attention, we believe, has been similarly allocated. The Current Regulation's domestic use election has been brought forward with limited structural change in the domestic use election contained in the Prop. Reg. §1.1503(d)-4(d). Importantly, however, the certification period for the domestic use election has been reduced to 7 years from 15 years and the rebuttal rules of the Current Regulations are to be replaced by a self-executing revenue procedure.

a. Election Mechanics

Generally the domestic use election provides that a DCL of DRC may be used against the income of a domestic affiliate if no portion of the DCL has been used to offset the income of a foreign person. Thus if the taxpayer agrees to forego the double dip (not use a DCL against the income of foreign affiliates), it will be permitted to deduct the DCL against the income of its U.S. affiliates. To avail itself of this election, the taxpayer must agree to continue to certify procedural compliance and the absence of foreign use for the 7 year certification period. If during the certification period, the requirements of the election are violated or the loss is utilized by a foreign person, the entire DCL subject to the election is recaptured as income in the year of the recapture event with an interest charge for the period from the original election until the recapture.

The domestic use election contained in the Current Regulations requires a statement for the year of election identifying the entity and the loss as well as a certification that "there has not been and will not be a foreign use of the dual consolidated loss . . . as well as a certification that arrangements have been made to ensure that there will be no foreign use of the dual consolidated loss during the certification period." The reference "and will not be" seems inappropriate in a representation or a certification because they do not usually relate to a future event. It is more in the nature of a covenant breach of which should give rise to a recapture event.

Under the Proposed Regulations, the domestic use election is unavailable if a triggering event occurs in the year in which the loss has been incurred. This rule is not as remote as it may seem, since foreign use may be triggered by the filing of a foreign tax return electing loss surrender which may not occur until after the U.S. tax return filing deadline. The new rule clarifies that this will not be a valid election followed by a later recapture event but instead an invalid election.

The domestic use election is not necessary where the taxpayer demonstrates to the satisfaction of the Commissioner that there is no possibility of foreign use by any means.[51] This demonstration requires a statement filed under penalties of perjury to be included with the income tax return for the year the loss is incurred. This statement must include a certified English translation of relevant foreign laws to establish the absence of potential foreign use. It is unclear whether this mechanic will be frequently used. Indeed, due to the Field Service Advice 200221018 stating that the "by-any-means" standard could rarely be satisfied, it is unlikely that it will be.[52]

b. <u>Recapture</u>

The domestic use election is terminated by a list of triggering events, the most significant of which is the actual foreign use of any portion of the DCL and the inability to continue the required certification during the certification period of seven years (the original year through the seventh following year).[53] Also included under Proposed Regulations as recapture triggering events are disaffiliation, affiliation, a 50% asset transfer, a 50% sale (or other disposition) of interest and the conversion to a foreign corporation. Any of these dispositions transfers an entity or assets with a stepped-up basis to another person, which renders further monitoring of the taxpayer election compliance impossible. The incorporation of a foreign unit has also been a triggering event because its income will not thereafter be subject to U.S. tax. Exceptions to triggering events are set forth including acquisitions by an existing member group.

[51] <u>*See*</u> *Prop. Reg. §1.1503(d)-4 (c).*
[52] *PLR 200221018 (Feb. 13, 2002).* We would advise that the words "by any means" be deleted from the Proposed Regulations as unnecessary so as to repudiate the holding of the FSA.
[53] *Prop. Reg. §1.1503(d)-4(d)(l)(v).*

(i) Dilution Recapture

The 'sale or disposition of interest' language for the asset and entity triggering events caused many practitioners to believe that a dilution transaction was not a triggering event, i.e. by a capital contribution into an existing hybrid entity through which new shares or ownership interests were issued but no shares were actually transferred or disposed of.

The Proposed Regulations treat partnership dilution as a foreign use. Thus, a hybrid entity's ownership changes by capital contribution so that loss carryforwards are made available for use by a person unrelated to the entity at the time the loss was generated, is treated as foreign use.[54] Foreign use means that the DCL is unavailable for the domestic use election, or if previously made, is subject to the recapture. This rule appears to be a change from the current Regulations. Under the Current Regulations, a recapture triggering event occurs only in the event of a disposition of assets or an interest in an entity.

RECOMMENDATION: We believe that the dilution rule in the Proposed Regulations is appropriate if the "all or nothing rule" is eliminated (as discussed below). However, if, contrary to our recommendation, the all or nothing rule is retained, we recommend that a dilution not require recapture if the taxpayer demonstrates to the satisfaction of the IRS that the dilution event does not permit the foreign holder to use the losses of the dual resident corporation or unit.

(ii) All or Nothing Rule

The reference to "any portion of a loss" in the foreign use definition is commonly referred to as the "all or nothing rule". The making available of any insignificant amount of loss calculated for U.S. purposes results in foreign use of the full loss and full recapture of a DCL previously deducted in the U.S. under a domestic use election. Thus, a dual resident corporation with a $1 billion dual consolidated loss, could not make a domestic use election (or a previously elected loss is recaptured) if $1.00 of the DCL were made available to a foreign affiliate. Similarly, a dual resident corporation having a substantial ordinary loss for the worthlessness of a subsidiary's stock that is not recognized as a taxable loss under foreign law, is not eligible for a domestic use election (or a previously elected loss is recaptured) if the loss of such subsidiary is generally available or if some insignificant quantum of other expense of the same entity was made available for use by a foreign entity. There is a true economic loss in this case without any significant double dip but the economic loss deduction is recaptured.

We think this "cliff effect" for domestic use election recapture seems inconsistent with the excellent policy choice made by the Treasury for proportionate

[54] *<u>See</u> Prop. Reg. §1.1503(d)-1(b)(14)(c)(2).*

treatment in the imposition of SRLY limitations on loss items. We suspect this choice was made because the Treasury feared that the IRS could not audit the myriad issues of foreign tax law necessary to determine the specific amount of DCL made available under foreign law. We think approaches exist to the potential concerns about administrability. Where foreign jurisdictions permit loss use only by specific acts of surrender, this would limit domestic use recapture to losses actually surrendered. Where losses are generally available pursuant to consolidation or fiscal unity regime, loss recapture could be limited to the portion deemed to offset foreign person income as indicated on certified copies of foreign tax returns. If the foreign tax base was substantially different than the U.S. tax base (calculated under Section 172(c)) apportionment could be used. The taxpayer's calculation could be supported by an opinion on foreign law and could be made "subject the satisfaction of the Commissioner" just as the Current Regulations recapture rebuttal provisions. *See, Reg. §1.1503-2(g)(2)(vii).* The Rebuttal Revenue Procedure could even be used to set forth methodologies for rebutting the amount of income to be recaptured.

In the final analysis, the dual consolidated loss limitation is inextricably tied to the operation of foreign tax law, for the foreign consolidation privilege if not for the actual calculation of foreign loss.

RECOMMENDATION: Therefore, we recommend that domestic use election loss recapture be limited to that portion of the loss which the taxpayer can demonstrate to the satisfaction of the Commissioner has in fact been used under foreign tax law. And as a corollary, we recommend that a domestic use election be available even if a triggering event occurs in the year in which the loss is incurred to the extent the taxpayer can demonstrate that the loss has not been used under foreign law.

c. Mirror Rule

The concept of "foreign use" determines when dual consolidated losses which are subject to the domestic use election must be recaptured (or cannot be the subject of the election in the first place). The mirror rule, a special circumstance of deemed foreign use, was introduced in the original regulations to address situations where foreign countries unilaterally disallow dual residents' losses. Such foreign law actually permits affected dual resident taxpayers to claim losses in the United States because the foreign use of such losses would have been disallowed under foreign law. A U.S. taxpayer might therefore make a domestic use election. Thus, mirror legislation could have been used by other countries to push all dual residency losses into the U.S. For this reason, the mirror rule treats the existence of mirror legislation as foreign use. The result is that the deduction is available nowhere other than against the future income of the DRC itself. This provision focuses on an important revenue preservation purpose and has been expressly tested in court[55]. The preamble in the new regulations brings forward the mirror rule without material change in the new regulations.

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[55] *British Car Auctions, Inc. v. U.S., 35 Fed. Cl. 123 (1996), aff"d per curiam 116 F.3d. 1497 (Fed. Cir. 1997)*

The mirror rule is designed to encourage countries to negotiate in their treaties or treaty protocols to address these dual resident taxpayer issues and resolve between the states as to which nation will permit the DRC a deduction of such loss. However, since 1989, no treaty negotiations, no protocol, no exchange of competent authority letters, nor any other resolution have occurred.

In addition, it is frequently a matter of ambiguity as to whether particular legislation is or is not mirror legislation. Initially, many of our treaty partners adopted rules providing that a company which was subject to a tax in another jurisdiction on a residence basis could not use its loss against the income of other affiliates in the country, see, e.g., U.K., Germany, Australia. Generally, such rules were not regarded as mirror rules unless the taxpayer was directly addressed by the legislation.[56] These provisions in general did not affect situations where the host country entity was a hybrid, transparent for U.S. purposes, whose attributes might flow to another foreign country but who itself was not subject to tax by the other country. More recently, the U.K. branch loss deduction and the U.K. anti-arbitrage legislation take more serious steps in this direction. U.K. 2003 legislation may not have been widely recognized as mirror legislation, but it is believed that Treasury regards it as such. In this instance, U.S. taxpayers may have claimed losses or filed domestic use elections in respect of losses which may be regarded as impermissible or subject to recapture by virtue of the deemed foreign use.

While the case for preventing foreign jurisdictions from pushing losses to the U.S. is clear enough, the mirror rule has produced no effective bilateral pressure to transform international practice. Moreover, because of the relatively stronger significance of dual consolidated losses to outbound investments, it is probable that most applications of the mirror rule will be to deny U.S. taxpayers deductions which are otherwise available. In this regard, it is our view that *British Car Auction* stands for the proposition that the mirror rule was one reasonable position for the regulations to take but not the only reasonable position. The case did not say that the regulations could not then, or now, take a different position. We regard the mirror rule as financial hardship imposed without sufficient clarity or limits to justify its application. We suggest that it would be appropriate for losses subject to mirror legislation to be made eligible for the domestic use election under rules comparable to non-mirror losses. We also recommend that the Treasury promulgate a mandatory competent authority procedure or similar arbitration to prevent the United States from bearing the entire amount of a dual consolidated loss in such instances.

RECOMMENDATION: Accordingly, we recommend that the mirror legislation rule be dropped and that mirror legislation not be deemed a foreign use that prevents a domestic use election. The taxpayer should be allowed to make a domestic use election for such loss. We recommend that the Treasury promulgate a mandatory competent authority procedure or similar arbitration to prevent the United States from bearing the entire amount of a dual consolidated loss in such instances.

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[56] See *F.S.A. 200101007.*

C. Other Procedural Rules

1. Recapture Rebuttal Revenue Procedure.

The Current and the Proposed Regulations allow the taxpayer to submit rebuttal evidence that no recapture event has occurred under their domestic use election. For this purpose the taxpayer must demonstrate, to the satisfaction of the Commissioner, that there can be no foreign use of the dual consolidated loss.[57] The taxpayer may also rebut the amount of recapture by a demonstration to the satisfaction of the Commissioner that the dual consolidated loss would have offset taxable income of the DRC if the loss had been fully subject to the SRLY limitation (*i.e.* would have offset its own income had no domestic use election been made).

We believe that the Revenue Procedure should set forth procedures and standards for such rebuttal showing. However, we also suggest that the Procedure set forth an additional rebuttal ground where recapture is not necessary to achieve the purposes of the dual consolidated loss limitation. In this regard, we think of situations like Example 29 where all dual consolidated loss has already offset income from or through the same separate unit.[58] The Procedure should create discretion within the IRS to overrule manifestly unintended and inappropriate results.

2. Reasonable Cause Exception

Procedurally, the Proposed Regulations contain a new reasonable cause exception for late filing. This is actually a procedural rule not strictly necessary to the basic operations of the DCL provisions. The IRS's view was that the timing requirements of compliance with the DCL rules regularly resulted in applications for 9100 relief, which the IRS was routinely granting. The IRS view was that this approval was before left to the administration of the IRS Director of Field Operations, who could assess in connection with the audit whether the failure was due to reasonable cause and not willful neglect. The application for reasonable cause exception must be made by an amended income tax return containing all the appropriate but previously omitted documents "once the person becomes aware of the failure". We think the reasonable cause exception appears to be a logical simplification of pushing down administration of the statute to field agents. Care should be taken to assure that such field agents will have the sophistication to reliably respond to a request for relief.

[57] *Reg. § 1.1503(d)-4(e)(2)and (b)(2).*
[58] *Reg. § 1.1503(d)-5(c)(example 29).*

3. Closing Agreements

The Current Regulations provide for the issuance of closing agreements where the entities potentially subject to domestic use election recapture have been sold to new taxpayers.[59] These closing agreements, detailed under Revenue Procedure[60], permit acquirers and sellers to continue the effect of an existing domestic use election where the disposition has not otherwise resulted in a true foreign use event. The Proposed Regulations largely replace these closing agreements by permitting acquirers in such circumstances to enter into a new domestic use election and agreement to continue the reporting rules of the prior taxpayer's election. We think this is a welcome reduction in the complexity and formality as closing agreements as authorized by Rev. Proc. 2000-42 require an extended process not always consistent with the timing of an acquisition transaction.

The preamble to the Proposed Regulations asks for views as to whether a closing agreement remains useful in certain circumstances. We believe that the renewal of the domestic use election is generally preferable. The IRS will always have authority to enter into closing agreements in particular circumstances where unique circumstances require it.

4. Effective Dates

The Current Regulations contain substantial ambiguities on many areas clarified by the Proposed Regulations. The Proposed Regulations as written specify that they shall be effective for losses incurred in years beginning after publication of the regulations in the federal register. We note that many areas such as branch and disregarded entity combination have been clarified and simplified under the Proposed Regulations in a manner which some felt was the correct legal interpretation of law under the Current Regulations. We think taxpayers ought to have the benefit of this clarification. On the other hand, in many situations, the clarification imported by the Proposed Regulations strikes some as not consistent with their reading of the Current Regulations or the statute they interpret. Such taxpayer's prior planning and compliance ought not to be upset by new provisions of the Proposed Regulations.

RECOMMENDATION: Accordingly, we recommend that taxpayers have the option to apply the Proposed Regulations in whole, but not in part, to open taxable years.

In addition, the Treasury asked for transition rules for all domestic use elections to interpret them under the new domestic use provisions. Among the differences are the reduction in the certification period from 7 years to 15 years. The Section believes that the existing domestic use certification period should be shortened to

[59] *See Reg. §1.1503-2(g)(2)(iv)(B)(3).*
[60] *Rev. Proc. 2000-42, 2000-2 C.B. 212.*

the shorter of the original time remaining or the shorter certification period under the Proposed Regulations. This would appear to be consistent with how the Treasury shortened the period for gain recognition agreements under the Section 367 rules to comport with new regulations. However, the change in substantive rules for the new domestic use election should not be imported into an existing domestic use election as that amounts to a retroactive change in an existing commitment of the taxpayer and the IRS that could have an unintended tax cost.