

Dual Consolidated Losses

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DCL Effective Date Provisions: Opportunities and Traps



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While generally prospective, the new final dual consolidated loss regulations (the “2007 regulations”) include several rules that apply to prior years or prior-year DCLs. These rules present immediate opportunities, but also include the proverbial traps for the unwary. Because of these opportunities and traps, an understanding of the effective date provisions is essential to proper DCL planning and compliance, especially during the upcoming return filing season.

Effective Date, in General

The 2007 regulations generally apply to DCLs incurred in tax years beginning on or after April 18, 2007.¹ Because this provision looks to the year a DCL is incurred, rather than the date the return is filed, Reg. §1.1503-2 (the “1992 regulations”) (as modified by the provisions discussed in this column) continues to apply to DCLs incurred in pre-effective date tax years.

Taxpayers may, however, elect to apply the 2007 regulations to DCLs incurred in tax years beginning on or after January 1, 2007.² Thus, many taxpayers will have to decide whether to apply the 1992 or the 2007 regulations with respect to DCLs incurred in their 2007 tax year. As illustrated by Examples 1 and 2, this choice can have a material impact:

Example 1. USP is a calendar-year taxpayer. In 2005, USP acquired an interest in PRS, a partnership for both U.S. and foreign tax purposes. PRS’s



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activities do not rise to the level of a foreign branch. Each year, USP incurs a \$100 net loss attributable to its interest in PRS. Under the 1992 regulations, USP's interest in PRS is a separate unit³ and USP's loss attributable to that interest is a DCL. Under the 2007 regulations, however, the loss attributable to USP's interest in PRS is not a DCL. (An interest in a non-hybrid partnership is not a separate unit under the 2007 regulations.⁴) As a result, USP can avoid the application of Code Sec. 1503(d) if it elects to apply the 2007 regulations to its 2007 tax year. Regardless of this election, however, the DCLs attributable to USP's interest in PRS for prior years will remain subject to the 1992 regulations, including the Reg. §1.1503-2(b) separate return limitation year (SRLY) limitations, or the potential triggering events under Reg. §1.1503-2(g)(2)(iii)(A).

Example 2. USP1 and USP2 are members of a consolidated group with a calendar-year tax year. Since 2005, USP1 has owned 100 percent of hybrid entity 1 (HE1) and USP2 has owned 100 percent of hybrid entity 2 (HE2), both organized under the laws of the same foreign country. Each year HE1 generates \$110 of income and HE2 incurs a <\$100> loss. Under the 1992 regulations, HE1 and HE2 are distinct separate units that cannot be combined and, as a result, USP2 has a DCL attributable to its interest in HE2.⁵ In contrast, the 2007 regulations combine HE1 and HE2 into a single separate unit, which has \$10 of net income.⁶ As a result, the consolidated group will have a DCL if it applies the 1992 regulations for 2007, but will not have a DCL if the 2007 regulations are elected. Regardless of whether the new regulations are applied in 2007, the prior-year DCLs attributable to USP2's interest in HE2 will remain subject to the 1992 regulations.

Election Procedure and Consistency Rule

In order to elect to apply the 2007 regulations to a tax year beginning on or after January 1, 2007, and before April 18, 2007, a taxpayer must attach to its return the "domestic use agreements, certifications, or other information in accordance with [the 2007] regulations."⁷ Thus, the 2007 regulations instruct taxpayers to make the election by complying with the 2007 regulations' filing requirements. Notably

lacking from this procedure is any guidance for taxpayers, similar to those in Examples 1 and 2, that have no filing obligations under the 2007 regulations. Presumably, such taxpayers can (and should) include a statement with their return notifying the IRS that they are electing to apply the 2007 regulations for the tax year.

Complicating the election to apply the 2007 regulations is an accompanying "consistency requirement." Pursuant to Reg. §1.1503(d)-8(a), a "taxpayer" must elect to apply the 2007 regulations "in their entirety."⁸ As a result, taxpayers⁹ must consider the potential application of each provision of the 2007 regulations to all of their operations when deciding whether to make the election. As Examples 1 and 2 illustrate, the 2007 regulations can provide a significant benefit. However, this will not always be the case. Given the expanded breadth of the 2007 DCL regulations, many taxpayers will likely decide that the cost of this election outweighs its benefits.

Certification Period

One of the most significant changes in the 2007 regulations is the reduced DCL certification and triggering event period. Under the 1992 regulations, a (g)(2) election required taxpayers to monitor their DCLs and separate units for 15 years.¹⁰ In contrast, the 2007 regulations reduce this period to five years.¹¹ Moreover, the 2007 regulations apply the new certification period retroactively, reducing the term of any outstanding (g)(2) election to five years.

In particular, Reg. §1.1503(d)-8(b)(1) provides that if "an event requiring recapture with respect to the dual consolidated loss subject to the [(g)(2)] agreement has not occurred as of the application date, then such [(g)(2)] agreement will be considered by the Internal Revenue Service to only apply for any tax year up to and including the fifth full tax year following the year in which the dual consolidated loss that is the subject of the agreement was incurred and thereafter will have no effect."¹²

The term "application date" means April 18, 2007, unless a taxpayer elects to apply the 2007 regulations for a year beginning on or after January 1, 2007, and before April 18, 2007. In that case, the application date is January 1, 2007.¹³

For DCL triggering events that occurred in early 2007, the interplay between the reduced certification period, the taxpayer's application date, and the election to apply the new regulations for a 2007 tax

year can determine whether a taxpayer has to include DCL recapture income.

Example 3. USP is a calendar-year taxpayer. Since January 1, 1998, USP has owned 100 percent of hybrid entity (HE). HE incurred DCLs in 1998 through 2006, and USP filed a (g)(2) election for each DCL. On March 1, 2007, USP sold its interest in HE to a third party. If USP elects to apply the regulations effective January 1, 2007, its application date is January 1, 2007, and USP has not had an event requiring recapture as of the application date. As a result, the five-year certification period applies, USP's (g)(2) elections for the tax years 1998 through 2001 terminate, and USP is only required to recapture the 2002 through 2006 DCLs. In contrast, if USP does not elect to apply the 2007 regulations effective January 1, 2007, its application date is April 18, 2007. In this situation, the five-year certification period does not apply, no (g)(2) elections terminate, and USP must recapture all of the HE DCLs.

Note that USP in Example 3 may also be faced with the issue of *how* to elect to apply the 2007 regulations effective January 1, 2007, if it did not incur any other DCLs in 2007. Again, this gap in the regulations can presumably be filled by attaching a statement to the 2007 return notifying the IRS of the election. Alternatively, if USP has other DCLs for 2007, the consistency rule would require USP to apply the 2007 regulations to these DCLs. In this case, USP could elect to apply the 2007 regulations by filing domestic use elections for these other DCLs in accordance with the 2007 regulations.

Relief for Late Filings

The 2007 DCL regulations also change the procedures for correcting omitted DCL filings.

Under the 1992 regulations, taxpayers corrected missed DCL certifications, elections, statements, or rebuttals by requesting “section 9100 relief” under Reg. §§301.9100-1 through -3. These requests were submitted to the IRS Office of the Associate Chief Counsel (International).

The 2007 regulations replace section 9100 relief with a reasonable cause procedure. Under this procedure, taxpayers can correct missed DCL filings by submitting a reasonable cause statement to the IRS Area Director, Field Examination, Small Business/Self

Employed or the Director of Field Operations, Large and Mid-Size Business (as applicable), as part of an amended return for the relevant year.¹⁴

The conversion from section 9100 relief to reasonable cause became effective with the issuance of the 2007 regulations, on March 19, 2007. Unlike the other effective date provisions, this rule does not consider the year the DCL was incurred or the year of the affected return, but instead looks to the date of the request for relief. As a result, and with one exception for late closing agreement requests (discussed below),¹⁵ all requests for relief submitted to the IRS after March 19, 2007 must be made under the reasonable cause provisions.¹⁶ For section 9100 relief requests pending as of March 19, 2007, the 2007 regulations permit, but do not require, taxpayers to withdraw these requests and resubmit them under the reasonable cause procedures.¹⁷

Triggering Event Exception for U.S. Acquirers

Both the 1992 and the 2007 regulations include a “successor-in-interest” triggering event exception. This exception applies when a domestic corporation or a consolidated group acquires a separate unit, a domestic owner of separate unit, or a dual resident corporation, and the transferee agrees to succeed to the prior-year (g)(2) or domestic use elections.¹⁸ Under the 1992 regulations, this exception generally required the transferor and the transferee to enter into a closing agreement with the IRS, agreeing to be jointly and severally liable for the total amount of the recapture of the DCL plus interest in the event of a future triggering event.¹⁹

In contrast, the 2007 regulations eliminate the closing agreement procedure and substitute rules that permit the acquiring consolidated group or corporation to enter into a new domestic use election (“multi-party transfer exception”).²⁰ Thus, closing agreements are not required under the 2007 regulations.

A special effective date accelerates the transition from closing agreements to the multi-party transfer exception, eliminating the closing agreement requirement for DCLs otherwise subject to the 1992 regulations. For triggering events after April 18, 2007, all transactions that previously required a closing agreement are instead subject to a modified version of the multi-party transfer exception, which utilizes the 2007 regulations’ procedures, but requires the acquirer to enter into a (g)(2) election and agree to remain subject to the 1992 regulations’ triggering

event rules.²¹ For triggering events occurring after March 19, 2007, but before April 18, 2007, a taxpayer can elect to apply the new multi-party transfer exception, but is not required to do so.²² The closing agreement requirement remains in place for triggering events before March 20, 2007.

Presumably because requests for both section 9100 relief and DCL closing agreements are submitted to the IRS Office of Associate Chief Counsel (International), the 2007 regulations retain Code Sec. 9100 relief for cases where a taxpayer failed to timely file a request for a closing agreement. Thus, a taxpayer with a pre-March 20, 2007, triggering event that fails to timely request a closing agreement is not eligible for the reasonable cause procedures.²³ However, this special rule only applies with respect to closing agreement requests, even if the same taxpayer omitted a closing agreement request as well as other DCL filings.²⁴

Example 4. USP is a calendar-year taxpayer that owns a separate unit (SU). SU incurred a DCL in 2005. On February 15, 2007, USP transferred 100 percent of its interest in SU to DC, an unrelated domestic corporation, in a transaction that would trigger the DCL unless USP and DC enter a closing agreement with the IRS. Because the February 15, 2007, acquisition date is outside the 2007 regulations' relief provisions, USP and DC are ineligible for the new multi-party event exception and instead must submit a request for a closing agreement. If USP and DC fail to timely request the closing agreement, they must request an extension of time under the section 9100 relief procedures. If, however, USP failed to file a (g) (2) election for the 2005 DCL, or failed to file a required annual certification on the 2006 return, USP would have to request relief for those filings under the reasonable cause procedures, even though it is also submitting a section 9100 relief request for the closing agreement.

Basis Adjustment Rules

As discussed in our previous column,²⁵ taxpayers may apply the new basis adjustment rules for all open years, even if the adjustment is attributable to a DCL incurred or recaptured in a closed year.²⁶ This provision provides a significant opportunity for taxpayers that recognized gain or loss with respect to stock (or an interest in a partnership) whose basis had been adjusted under the 1992 regulations.

Example 6. USP owned an interest in PRS, a hybrid partnership, with a \$50 adjusted basis. In 2002, USP incurred a \$50 DCL attributable to its interest in PRS and did not make a (g)(2) election. As required by the 1992 regulations, USP reduced its basis in PRS to \$0. In 2005, USP sold its interest in PRS and recognized \$50 of gain.

Under the 2007 final regulations, USP would not have been required to reduce its basis in PRS and, as a result, would not have recognized any gain on the sale. Under the new regulations' special effective date, S can now amend its tax return for the 2005 tax year and reduce its taxable income by the \$50 gain. This result is authorized by the new regulations notwithstanding that the 2002 year (the year USP first adjusted its PRS basis to account for the DCL) may be closed.²⁷

Conclusion

Found at the end of the 2007 regulations, after the regulations' 40 examples, the DCL effective date provisions may be overlooked. However these rules merit careful attention. If properly applied, the effective dates can help taxpayers minimize their DCL exposure. If improperly applied (or ignored), the effective date rules may unnecessarily increase taxpayers' DCL amounts and potential future recapture.

ENDNOTES

¹ Reg. §1.1503(d)-8(a).

² *Id.*

³ Reg. §1.1503-2(c)(3)(i)(B).

⁴ See Reg. §1.1503(d)-1(b)(4).

⁵ See Reg. §1.1503-2(c)(3)(ii) (separate unit combination rule under the 1992 DCL regulations).

⁶ Reg. §1.1503(d)-1(b)(4)(ii). As compared to the 1992 regulations, the 2007 separate unit combination rule is greatly expanded.

⁷ Reg. §1.1503(d)-8(a).

⁸ Compare Reg. §1.367(a)-8T(h)(2), permitting taxpayer to apply all or part of the new Code Sec. 367 gain recognition agreement (GRA) regulations to prior year GRAs, though only with respect to the Reg. §1.367(a)-8T rules that "were not already effective" under the prior Reg. §1.367(a)-8 regulations.

⁹ The regulation does not specifically address the application of the consistency rule to a group of U.S. corporations that files a consolidated return. As a result,

an issue exists whether each member corporation is a "taxpayer" separately subject to the consistency rule or, instead, whether the group as a whole is required to apply the 2007 regulations consistently to all the group's separate units or dual resident companies. Compare Proposed Reg. §1.987-11(b) (providing that an election to retroactively apply the proposed Code Sec. 987 regulations is binding on all members that file a consolidated

ENDNOTES

- return with such taxpayer).
- ¹⁰ See Reg. §1.1503-2(g)(2)(vi)(B); *see also*, Reg. §1.1503-2(g)(2)(iii)(A)(1).
- ¹¹ Reg. §1.1503(d)-1(b)(20). *See also* Reg. §1.1503(d)-6(e) (a DCL must be recaptured if a triggering event occurs during the certification period).
- ¹² Reg. §1.1503(d)-8(b)(1). This provision also applies to DCLs subject to an agreement under the prior Reg. §1.1503-2A regulations. A similar provision applies with respect to DCLs subject to DCL closing agreements, provided the closing agreement is still in effect as of the application date and the DCL has not been recaptured. Reg. §1.1503(d)-8(b)(2). *See also* Announcement 2007-49, correcting the 2007 DCL regulations as originally published in the Federal Register on March 19, 2007.
- ¹³ Reg. §1.1503(d)-8(a).
- ¹⁴ Reg. §1.1503(d)-1(c). *See also*, Notice 2006-13, IRB 2006-8, 496, which accelerated application of the reasonable cause procedures by allowing taxpayers to elect to apply the reasonable cause rules of then-outstanding Proposed Reg. §1.1503(d)-1.
- ¹⁵ Reg. §1.1503(d)-8(b)(3)(ii).
- ¹⁶ Reg. §1.1503(d)-8(b)(3)(i).
- ¹⁷ Reg. §1.1503(d)-8(b)(3)(iii).
- ¹⁸ Reg. §§1.1503-2(g)(2)(iv)(B)(1) (1992 regulations) and 1.1503(d)-6(f)(2) (2007 regulations).
- ¹⁹ Reg. §§1.1503-2(g)(iv)(B)(1) and 1.1503-2(g)(iv)(B)(3). A limited exception to the closing agreement requirement applied if an unaffiliated domestic corporation became a member of an affiliated group or a consolidated group ceased to exist as a result of a transaction described in Reg. §1.1502-13(j)(5)(i). *See* Reg. §1.1503-2(g)(iv)(B)(2); *see also* Irwin Halpern and John Merrick, *Proposed Regulations Addressing Dual Consolidated Loss Closing Agreements – A Small Step in the Right Direction*, J. TAX'N GLOBAL TRANS., Winter 2003, at 65 (discussing 2002 proposed revisions to the 1992 regulations eliminating the closing agreement requirement in these circumstances, which were made final in 2003).
- ²⁰ Reg. §1.1503(d)-6(f)(2).
- ²¹ Reg. §1.1503(d)-8(b)(4). The new multi-party transfer exception will only apply with respect to triggering events that would have required a closing agreement under the 1992 regulations. As a result, transactions that only require a new (g)(2) election under the 1992 regulations (transactions described in Reg. §1.1503-2(g)(2)(iv)(B)(2)) remain subject to those provisions.
- ²² Reg. §1.1503(d)-8(b)(4).
- ²³ Reg. §1.1503(d)-8(b)(3)(ii).
- ²⁴ *See* Reg. §1.1503(d)-8(b)(3)(i).
- ²⁵ Irwin Halpern and Christopher Trump, *Dual Consolidated Losses, 2007 Final Regulations: New Basis Adjustment Rules*, INT'L TAX J., Jan.–Feb. 2008, at 9.
- ²⁶ Reg. §1.1503(d)-8(b)(5).
- ²⁷ As described in our previous column, the basis adjustment rule effective date presents many other potentially beneficial opportunities.

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