

Dual Consolidated Losses

By Irwin Halpern and Chris Trump

AM 2008-007: Separate Unit Combination and the Exceptions to Foreign Use

Introduction

Two fundamental changes included in the 2007 dual consolidated loss regulations¹ (the “2007 Regulations”) are the separate unit combination rule² and the new definition of foreign use.³ The 2007 Regulations include numerous provisions describing and applying each of these rules.⁴ However, the regulations provide limited guidance as to how the two provisions interact.

In recognition of this uncertainty, and in response to questions raised by taxpayers and their advisors, the IRS published a Legal Advice Memorandum (the “AM”)⁵ addressing how two exceptions to foreign use apply to the disposition of an interest in a hybrid partnership that is part of a combined separate unit. The AM provides extremely helpful guidance and represents an important first step in coordinating the foreign use and separate unit combination rules. However, as always, further questions remain.

The Combination Rule

Combining same-country separate units can be beneficial. For example, if a taxpayer’s combined separate unit has positive net income that separate unit will not have a DCL, notwithstanding that certain component parts of the combined separate unit incurred a net loss for the year. On the other hand the combination rule can also be detrimental, for example, by expanding the scope and impact of the DCL triggering events. In either case, the combination rule has a significant role in DCL planning and compliance.



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Combination Under the 1992 Regulations

Under the 1992 final regulations⁶ (the “1992 Regulations”), same-country separate units are treated as a single combined separate unit only if all of the following conditions are satisfied⁷: (1) the separate units are foreign branch separate units⁸; (2) the foreign branches are owned by a single domestic corporation; and (3) the losses of each branch are made available to offset the income of the other branch or branches under foreign law. Thus, the 1992 Regulations do not combine separate units that are not foreign branches, do not combine foreign branches owned by multiple members of a consolidated group⁹ and do not combine foreign branches whose losses do not offset the income of each other.¹⁰

Combination Under the 2007 Regulations

The 2007 Regulations substantially expand the scope of the combination rule, removing all three requirements of the 1992 Regulations. As a result, except in the case of separate units of certain foreign insurance companies,¹¹ if a domestic owner, or two or more domestic owners that are members of the same consolidated group, have two or more separate units (individual separate units), then all individual separate units that are located (in the case of a foreign branch separate unit) or subject to an income tax on either their worldwide income or on a residence basis (in the case of an interest in a hybrid entity separate unit) in the same foreign country are combined and considered one separate unit.¹²

The combination rules of both the 1992 and the 2007 Regulations are “mandatory.” In other words, if the regulatory requirements are met, a domestic owner (or consolidated group with multiple domestic owners) cannot choose whether or not to combine the individual separate units. However, unlike the 2007 Regulations, the 1992 Regulations included an “easy out”: a consolidated group could avoid the combination rule by having its same-country branch activities conducted by different members of the consolidated group. In contrast, the 2007 Regulations do not contain this exception and, as a result, indeed require combination of all same-country separate units carried on by a consolidated group—branches as well as interests in hybrid entities.

Finally, in order to make clear the effect of the combination rule under the 2007 Regulations,

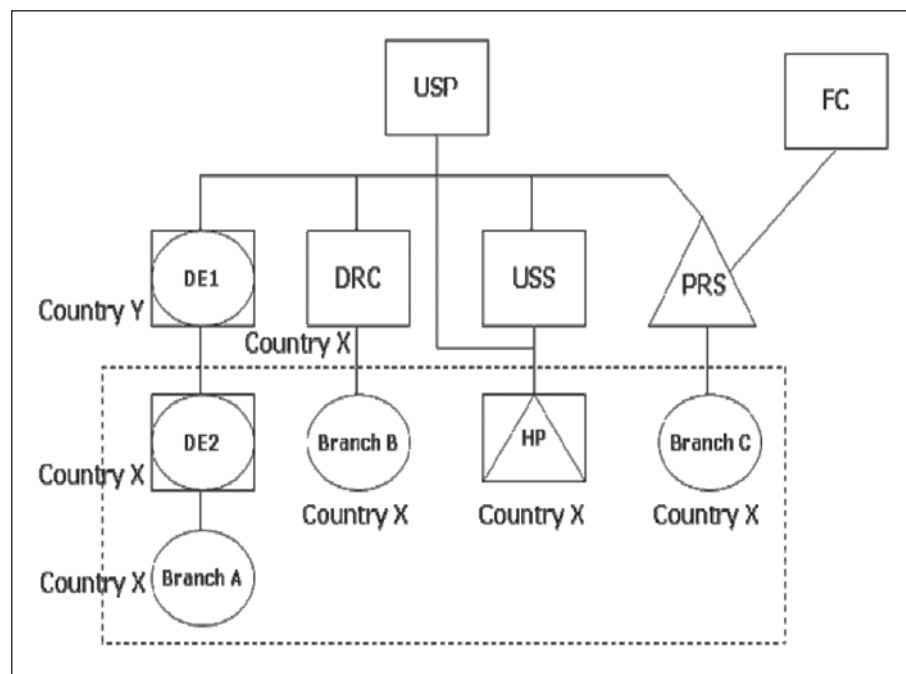
Reg. §1.1503(d)-1(b)(4)(ii) provides that, except as specifically provided,¹³ “any individual separate unit composing a combined separate unit loses its character as an individual separate unit.” Accordingly, a domestic owner or consolidated group must generally apply the provisions of the 2007 Regulations treating the combined separate unit as a single separate unit. For example, a domestic owner must look to the total fair market value of the combined separate unit’s assets (rather than the fair market value of each individual separate unit composing the combined separate unit) in measuring whether a transfer of assets results in a presumptive triggering event.¹⁴

The following example illustrates the 2007 Regulations’ separate unit combination rule:

Example 1.¹⁵ USP, a domestic corporation and parent of a consolidated group, owns DE1, a disregarded entity subject to an income tax on its worldwide income in Country Y. DE1 in turn, owns DE2, another disregarded entity subject to an income tax on its worldwide income in Country X. DE2 carries on activities in Country X that rise to the level of a foreign branch (“Branch A”). In addition, USP owns DRC, a Country X dual resident corporation and a member of the P consolidated group. DRC carries on business operations in Country X that constitute a foreign branch (“Branch B”). USP also owns a 50-percent interest in PRS, an entity treated as a partnership for both U.S. and Country X tax purposes. An unrelated foreign person owns the remaining 50-percent interest in PRS. PRS carries on activities in Country X that rise to the level of a foreign branch (“Branch C”). Finally, USP and USS, a wholly owned domestic subsidiary of USP, each own 50 percent of HP, an entity subject to Country X income tax on its worldwide income. HP is treated as a partnership for U.S. federal income tax purposes. (See Diagram 1.)

Under the 2007 Regulations, the USP group has a combined Country X separate unit comprised of the following component parts: USP’s interest in DE2, Branch A, Branch B, USP’s interest in Branch C, and both USP’s and USS’s interests in HP. This is the case regardless of whether the losses of each individual separate unit are made available to offset the income of the other individual separate units under Country X tax law.¹⁶

Diagram 1



Foreign Use

The definition of foreign use is the lynchpin of both the 1992 and 2007 Regulations. The presence of a foreign use determines whether a DCL can be used to offset the income of a domestic affiliate or if the domestic use limitation applies. In addition, a foreign use of a previously certified DCL triggers the DCL recapture and interest charge rules.

As a result, one of the most significant changes included in the 2007 Regulations is its revised definition of foreign use. In particular, while the 1992 Regulations looked to whether the DCL was made available “to offset the income of any other person under the income tax laws of a foreign country,”¹⁷ the 2007 Regulations apply a two-step inquiry that considers both foreign and U.S. income tax law and principles to determine whether a foreign use has occurred.¹⁸

The Basic Rule

Under Reg. §1.1503(d)-3(a)(1), a foreign use is generally deemed to occur when “any portion of a deduction or 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,¹⁹ any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of: (i) A foreign corporation as defined in section 7701(a)(3) and (a)(5); or (ii) A direct or indirect

owner of an interest in a hybrid entity, provided such interest is not a separate unit.”

Thus, a foreign use occurs if two conditions are met. First, an item of loss or deduction taken into account in computing the DCL must be made available, *under foreign law*, to offset income (either directly or indirectly). This prong focuses solely on the foreign law treatment of the item of loss or deduction included in the DCL. In cases where availability exists under foreign law, the second prong asks *under U.S. tax principles* whether the loss is made available to offset income that is not subject to U.S. tax. In other words, a foreign use is present if the loss is made available to offset income other than income

of a domestic corporation (or a separate unit of a domestic corporation).

The Treasury and the IRS first articulated the revised definition of foreign use in the proposed DCL regulations, issued in 2005.²⁰ The preamble to the proposed regulations explains the government’s thinking:

The IRS and Treasury understand that issues arise involving the application of the use rule contained in the current [1992] regulations. For example, issues may arise where items of income, gain, deduction and loss are treated as being generated or incurred by different persons under U.S. and foreign law. Similarly, issues may arise due to the different definitions of a *person* under U.S. and foreign law. These issues have become more prevalent since the adoption of the entity classification regulations under §§301.7701-1 through 301.7701-3.

The IRS and Treasury also understand that taxpayers have taken positions under the current regulations regarding the use of a dual consolidated loss that are inconsistent with the policies underlying section 1503(d). On the other hand, the IRS and Treasury believe that, under the current regulations, a use can be deemed to occur in certain cases where there may be little likelihood of the type of double-dip that section 1503(d) was intended to prevent.

For the reasons discussed above, the proposed regulations modify the definition of *use* and provide a rule based on *foreign use*. These modifications are intended to minimize the potential over- and under-application of the dual consolidated loss rules that can occur under the current regulations. Under the proposed regulations, the foreign use definition is intended to minimize the opportunity for a double-dip. However, the new definition is also intended to minimize the situations in which a foreign use will occur in cases where there may be little likelihood of a double-dip.²¹

The following example illustrates the 2007 Regulations' definition of foreign use:

Example 2.²² USP, a domestic corporation and parent of a consolidated group, owns DRE1, a disregarded entity subject to tax on its worldwide income in Country X. S, a wholly owned subsidiary of USP and a member of the USP consolidated group, owns DRE2, a disregarded entity that is also subject to tax on its worldwide income in Country X. DRE1 owns 99 percent and DRE2 owns one percent of RH1, a Country X partnership that elected to be treated as a corporation

for U.S. tax purposes. RH1 conducts a trade or business in Country X. In year 1, DRE1 incurs interest expense on a third-party loan, creating a DCL attributable to USP's interest in DRE1. In addition, and also in year 1, DRE1 takes into account its distributive share of RH1 income (if any) for Country X tax purposes. (See Diagram 2.)

Applying Reg. §1.1503(d)-3(a)(1), an item of loss or deduction composing USP's DCL attributable to its interest in DRE1 is made available to offset income under the laws of Country X because RH1 is treated as a flow-through entity for Country X tax purposes.²³ In addition, RH1 is treated as a foreign corporation under U.S. tax principles. Accordingly, both prongs of the foreign use test are met, a foreign use has occurred and, as a result, USP cannot make a domestic use election with respect to DRE1's DCL.

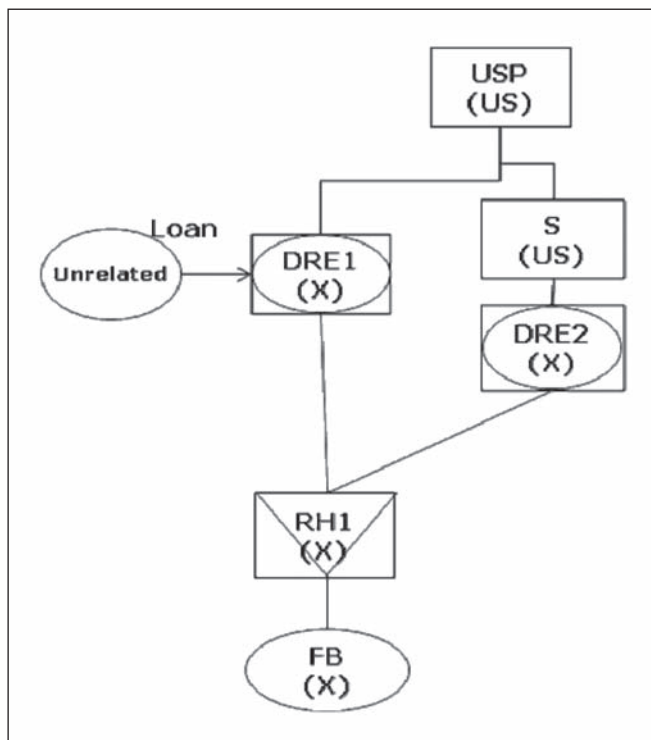
Exceptions to Foreign Use: Partnerships, Grantor Trusts and Other Separate Units

As noted above, the 2007 Regulations' definition of foreign use casts a very broad net. Accordingly, if applied without exception, the revised definition could result in a foreign use in circumstances far beyond the policies of Code Sec. 1503(d), including standard cross-border joint ventures. Recognizing this potential, the IRS and the Treasury included in the 2007 Regulations a number of exceptions intended to refine and focus the foreign use provisions.²⁴

In addition to these specific exceptions, the IRS and the Treasury included a "catch all provision" intended to facilitate further development of the foreign use definition. Pursuant to Reg. §1.1503(d)-3(c)(9) "[t]he Commissioner may provide, by guidance published in the Internal Revenue Bulletin, that certain events or transactions do or do not result in a foreign use."²⁵ Under this provision the IRS and the Treasury can supplement the 2007 Regulations without formal amendment. Although the preamble to the regulations requested comments regarding additional foreign use exceptions that might be added pursuant to this authority,²⁶ to date the IRS and the Treasury have not issued any such guidance.

Interests in Partnerships and Grantor Trusts: The "(c)(4) Exception." With respect to joint ventures, Reg. §1.1503(d)-3(c)(4) provides an exception appli-

Diagram 2



cable to a DCL attributable to a separate unit that is an interest in a hybrid entity partnership or hybrid entity grantor trust or to a separate unit that is owned indirectly through a partnership or grantor trust (the “(c)(4) exception”).²⁷ Under the (c)(4) exception, “a foreign use will not be considered to occur if the foreign use is solely as the result of another person’s ownership of an interest in the partnership or grantor trust, as applicable, and the allocation or carry forward of an item of deduction or loss composing such dual consolidated loss as a result of such ownership.”

The (c)(4) exception does not, however, apply if the domestic owner’s interest in the partnership or grantor trust is reduced by more than a *de minimis* amount at any time following the year when the DCL is incurred. (This rule is referred to as the “(c)(4) limitation”).²⁸ For this purpose, a more than *de minimis* reduction occurs if after the year in which the DCL was incurred either (1) the domestic owner’s interest is reduced, within any 12-month period, by 10 percent or more, as determined by reference to the domestic owner’s interest at the beginning of the 12-month period; or (2) the domestic owner’s interest is reduced by 30 percent or more, in total, as determined by reference to the domestic owner’s interest at the end of the tax year in which the DCL was incurred.²⁹

In applying the (c)(4) limitation, a reduction of a domestic owner’s interest can arise from a sale or exchange, but also by any other means, including another person’s contribution or, presumably, an amendment to the partnership agreement.³⁰ The regulations also describe how to measure a “reduction.” In the case of an interest in a hybrid entity partnership or a separate unit that is carried on or owned through a partnership, a reduction is measured by reference to the owner’s interest in the profits or the capital in the separate unit.³¹ In the case of an interest in a hybrid entity grantor trust or a separate unit that is carried on or owned through a grantor trust, a reduction is measured by reference to the domestic owner’s share of the separate unit’s assets and liabilities.³²

The following examples³³ illustrate the (c)(4) exception:

Example 3. USP, a domestic corporation, owns 80 percent of HPS, a Country X entity treated as a partnership for U.S. tax and subject to Country X tax on its worldwide income. F, an unrelated foreign corporation, owns the remaining 20 percent of HPS. In year 1, HPS incurs a loss of \$100, \$80 of which is attributable to USP’s interest in HPS (a hybrid entity separate unit). The \$80 loss constitutes a DCL and USP makes a domestic use election with respect to the loss. In year 2, HPS generates \$50 of income, \$40 of which is attributable to USP’s interest in HPS. Under Country X income tax laws, the \$100 of year 1 loss incurred by HPS is carried forward and offsets the \$50 of income generated by HPS in year 2.

In applying the (c)(4) limitation, a reduction of a domestic owner’s interest can arise from a sale or exchange, but also by any other means, including another person’s contribution or, presumably, an amendment to the partnership agreement.

In year 2, the \$80 DCL attributable to USP’s separate unit is “made available” to offset HPS’s year 2 income, by reason of the carry forward of \$100 loss under Country X law. In addition, \$10 of such income is, under U.S. federal income tax principles, attributable to F’s interest in HPS, which is an interest in a hybrid

entity that is not a separate unit. As a result, under the general foreign use definition, the year 1 DCL would be treated as having been made available for a foreign use and USP would be required to recapture its year 1 DCL. However, pursuant to the (c)(4) exception, no foreign use of the year 1 DCL is treated as having occurred because in year 2 there has been no reduction in USP’s interest in HPS.

Example 4. Same facts as Example 3, except that USP also owns FS, a Country X entity that is a controlled foreign corporation for U.S. tax purposes. In year 2, FS and HPS elect to file a consolidated return under Country X law. In this case, the (c)(4) exception does not apply because the foreign use arises as a result of the FS-HPS loss sharing. That is, the (c)(4) exception would only apply if the foreign use arose as a result of FS’s ownership in HPS and the allocation or carry forward of a loss as a result of that ownership.

Example 5. Same facts as Example 3, except that, at the end of year 2, F contributes cash to HPS in exchange for additional equity of HPS. As a result of the contribution, F's interest in HPS increases from 20 percent to 30 percent, and USP's interest in HPS decreases from 80 percent to 70 percent. In this case, the (c)(4) limitation prevents the (c)(4) exception from applying because USP's interest in HPS is reduced by greater than 10 percent (12.5 percent, 10/80) within a 12-month period. With the (c)(4) exception turned off, the general foreign use definition applies and, as a result, a portion of USP's DCL is considered made available to offset F's income in year 2.

Reg. §1.1503(d)-3(c)(4)(ii), in an attempt to coordinate the (c)(4) exception with the separate unit combination rule, provides that the (c)(4) exception only applies to that portion of the DCL of a combined separate unit that is attributable to an individual separate unit that is eligible for the (c)(4) exception.³⁴ In other words, Reg. §1.1503(d)-3(c)(4)(ii) clarifies that the (c)(4) exception cannot in any way "shelter" a combined separate unit from other incidents of foreign use. However, this provision does not address other complexities raised by the interaction of the foreign use exceptions and the combination rule.

Interests in Other Separate Units: The (c)(5) Exception. In addition to the (c)(4) exception addressing interests in partnerships and grantor trusts, the 2007 Regulations include a separate exception addressing situations in which a foreign use might arise as a result of a transfer or shifting of a domestic owner's interest in a separate unit. Pursuant to Reg. §1.1503(d)-3(c)(5), "no foreign use shall be considered to occur with respect to a dual consolidated loss as a result of an item of deduction or loss composing such dual consolidated loss being made available solely as a result of a reduction in the domestic owner's interest in the separate unit."

The (c)(5) exception is similar to the (c)(4) exception in two important ways. First, the two provisions share the broad definition of "disposition" (discussed above). In addition, the exceptions also share the

definition of a *de minimis* reduction. Accordingly, the (c)(5) exception will not apply if either (1) the domestic owner's interest is reduced, within any 12-month period, by 10 percent or more, as determined by reference to the domestic owner's interest at the beginning of the 12-month period; or (2) the domestic owner's interest is reduced by 30 percent or more, in total, as determined by reference to the domestic owner's interest at the end of the taxable year in which the DCL was incurred.³⁵

Interestingly, the (c)(5) exception was not included in the 2005 Proposed Regulations, but was added as part of the 2007 Regulations.³⁶ Neither does the preamble to the 2007 Regulations discuss the (c)(5) exception in detail. Finally, apart from the very narrow rule of Reg. §1.1503(d)-3(c)(4)(ii), there is no discussion or coordination of the

interaction between the (c)(4) exception, the (c)(5) exception and the separate unit combination rule.

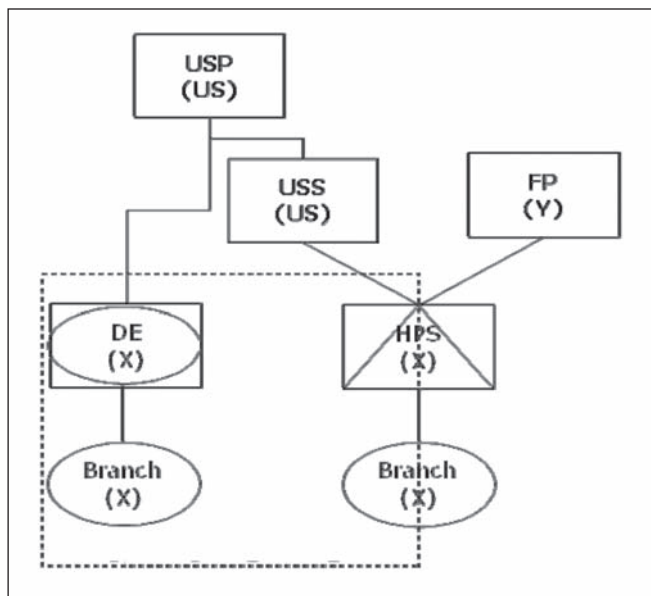
One such other area in which guidance would be welcomed and which is closely related to the issues discussed in the AM is how the *de minimis* rules apply in the case of a transfer of an interest in a disregarded entity or a foreign branch separate unit.

Legal Advice Memorandum 2008-007

Legal Advice Memorandum 2008-007 picks up where the regulations leave off and provides guidance on the coordination of the (c)(4) and (c)(5) exceptions and the separate unit combination rule. Issued in response to comments from taxpayers and their advisors, the AM represents an important first step in rationalizing and coordinating these complex rules. The AM provides its analysis by setting forth three factual scenarios, and then discussing and describing how the foreign use exceptions and combination rule apply and interact in each case.

Facts

USP is a domestic corporation and parent of a consolidated group. USP owns 100 percent of USS, a domestic corporation and member of the USP group. USP also owns 100 percent of DEx, a Country X hybrid entity. DEx carries on activities in Country X that rise to the level of a foreign branch. In addition, USS owns 50 percent of HPSx, a Country X hybrid entity that is treated as a partnership for U.S. tax purposes.

Diagram 3

The remaining 50 percent of HPSx is owned by FPy, an unrelated Country Y corporation. HPSx carries on activities in Country X that rise to the level of a foreign branch. (See Diagram 3.)

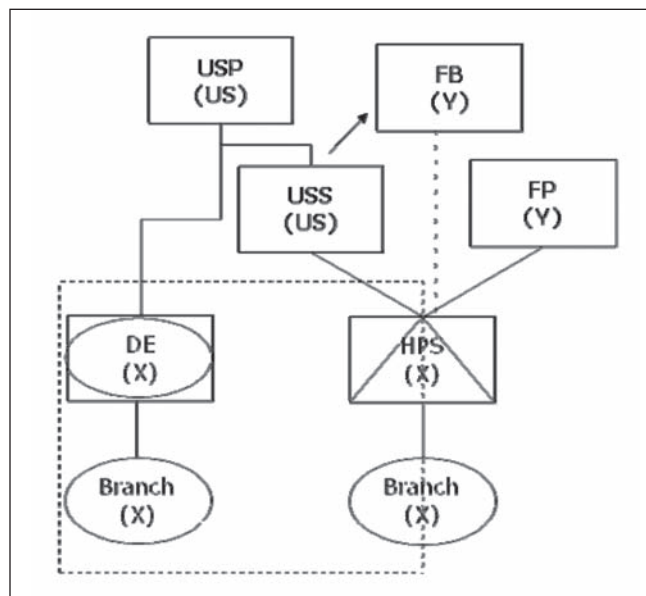
Under the 2007 Final Regulations, USP's interest in DEX, DEX's activities, USS's interest in HPSx and USS's interest in the activities carried on by HPSx are treated as a single combined separate unit.³⁷ In year 1, the combined separate unit incurred a DCL and USP made a domestic use election.³⁸ HPSx also incurred a loss for Country X purposes in year 1, which carried forward into year 2. But for the (c)(4) exception, there would be a foreign use of the year 1 DCL in year 2 as a result of the carry forward.³⁹

Scenario 1

At the end of year 2, USS sells half of its 50-percent interest in HPSx to FBy, a Country Y corporation. As a result of the sale, USS's percentage interest in HPSx is reduced by 50 percent (that is, from 50 percent to 25 percent). However, USP's and USS's total percentage interest in the combined separate unit is reduced by less than 10 percent. (See Diagram 4.)

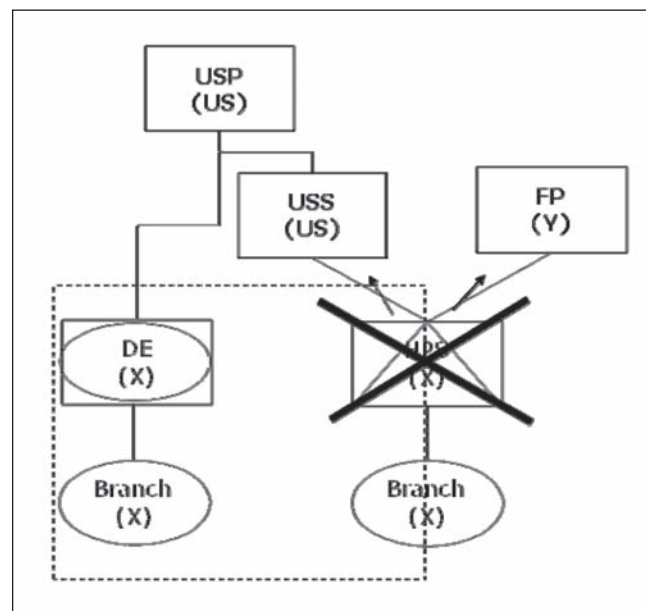
Scenario 2

At the end of year 2, USS sells its entire interest in HPSx to FBy, a Country Y corporation. As a result of the sale, USS's percentage interest in HPSx is reduced by 100 percent (that is, from 50 percent to zero). In addition, USP's and USS's percentage interest in the combined separate unit is reduced by 10 percent or more. (See Diagram 4.)

Diagram 4

Scenario 3

At the end of year 2, USS and FPy decide to terminate HPSx. As a result, HPSx distributes its property to USS and FPy in liquidation. From a U.S. tax perspective, the distribution is in respect of USS's and FPy's respective partnership interests. After the liquidation, the HPSx assets distributed to USS continue as an individual separate unit that is part of the combined separate unit. (See Diagram 5.)

Diagram 5

Discussion

The AM addresses an apparent inconsistency between the (c)(4) and (c)(5) exceptions. On the one hand, the (c)(4) limitation, by its terms, restricts the (c)(4) exception to cases where there is less than a *de minimis* reduction in “the partnership or grantor trust.” By referencing these individual separate units, the (c)(4) limitation appears to operate regardless of whether such individual separate unit is part of a combined separate unit. On the other hand, the (c)(5) exception applies the *de minimis* exception to a domestic owner’s interest “in the separate unit.” Applying the rule that generally regards the combined separate unit as “the separate unit,”⁴⁰ the (c)(5) exception applies the *de minimis* rules on a combined separate unit basis.

Scenario 1 frames and highlights the apparent inconsistency between the (c)(4) and (c)(5) exceptions. USS’s sale of half of its 50-percent interest in HPSx reduces its interest in the hybrid partnership by 50 percent, an amount in excess of the limit set by the (c)(4) limitation, but reduces its interest in the combined separate unit by less than 10 percent, a reduction that could still entitle it to the (c)(5) exception. Acknowledging the need to reconcile these two rules, the AM admits the lack of clear guidance: “there is no rule that explicitly provides how the (c)(4) limitation applies to a separate unit held only in part by reason of a partnership interest, such as the Combined Separate Unit held by USP and USS.”

The AM then goes on to reach an eminently sensible result. As it states: “the (c)(4) limitation should be applied based on a reduction in the percentage interest in the partnership interest, but only to the extent that the reduction in the partnership interest has the effect of more than a *de minimis* reduction in the entire separate unit (which would include other individual separate units composing a combined separate unit that are not held by reason of the partnership interest).” As the AM notes, there is no policy reason to apply the (c)(5) exception based on the entire combined separate unit, but the (c)(4) limitation based on individual separate units. Having adopted the (c)(5) exception as the appropriate measure of a *de minimis* reduction in the separate unit, that measure should be consistently applied. Accordingly, the AM provides that the (c)(4) limitation does not apply in Scenario 1 and

thus the (c)(4) exception prevents any foreign use from occurring.

In contrast, the disposition in Scenario 2 does result in a reduction of 10 percent or more of the combined separate unit. In this case the (c)(4) limitation and the (c)(5) exception consistently provide that the *de minimis* limit is exceeded. Accordingly, the AM provides that a foreign use has occurred in Scenario 2.

Finally, Scenario 3 addresses the liquidation of HPSx. As a result of the liquidating distribution, there is a 100-percent reduction in USS’s interest in HPSx. However, the liquidation did not change USP’s and USS’s percentage interest in the combined separate unit (recall that after the liquidation the HPSx assets distributed to USS continue as an individual separate unit that is part of the combined separate unit). Accordingly, with no reduction in the combined separate unit, the (c)(4) limitation clearly does not apply, and the (c)(4) exception prevents the occurrence of a foreign use.

Conclusion

The AM provides helpful and much needed guidance for taxpayers applying the (c)(4) exception in the context of a combined separate unit. In light of its significance, the IRS and the Treasury should consider publishing the AM’s analysis and conclusions in the Internal Revenue Bulletin, pursuant to the authority granted in Reg. §1.1503(d)-3(c)(9). In addition to more formally memorializing the AM, an Internal Revenue Bulletin publication could serve as a first step in an ongoing dialogue with taxpayers and their representatives clarifying and refining additional points under the 2007 Regulations.

One area in which guidance would be welcomed, closely related to the issues discussed in the AM, is how the *de minimis* rules apply in the case of a transfer of an interest in a disregarded entity or a foreign branch separate unit. In particular, although the 2007 Regulations provide specific rules for measuring whether there has been a more than *de minimis* reduction in the interest of a partnership or grantor trust, the regulations do not provide guidance on how to measure the amount of a foreign branch or hybrid entity separate unit that is a disregarded entity that is transferred for purposes of the *de minimis* exception. Moreover, the regulations do not provide clear guidance as

to how to apply the *de minimis* exception to combined separate units that include different types of individual separate units. For example, Scenario 1 of the AM states that USP's and USS's total percentage interest in the combined separate unit is reduced by less than 10 percent as a result of USS's sale of half of its interest in HPSx. However, the AM does not provide a basis for this conclusion, and it is unclear how USP's interest in DEx and USS's interest in HPSx are properly compared for

the purpose of determining the group's overall reduction in its combined separate unit.

Reg. §1.1503(d)-3(c)(9) provides an excellent opportunity to address these and other issues that will arise as practitioners and the government gain experience with the 2007 Regulations. Hopefully, the IRS and the Treasury will continue the momentum set by the AM and use this regulatory authority to formalize the AM's conclusions and to provide further useful guidance.

ENDNOTES

¹ T.D. 9315, IRB 2007-15, 891; 72 FR 12,902.

² Reg. §1.1503(d)-1(b)(4)(ii).

³ Reg. §1.1503(d)-3.

⁴ See, e.g., Reg. §§1.1503(d)-1(b)(4)(ii) and 1.1503(d)-3(c)(1)–(8). See also, Reg. §1.1503(d)-7(c), Examples 1, 8, 14–16, 19 and 26.

⁵ AM 2007-003 (June 25, 2008).

⁶ T.D. 8434, 1992-2 CB 240; 57 FR 41,079 (Sept. 9, 1992).

⁷ Reg. §1.1503-2(c)(3)(ii).

⁸ The practical effect of limiting the 1992 Regulations' combination rule to foreign branch separate units (as compared to hybrid entity separate units) is somewhat unclear in light of the IRS's recent pronouncements indicating that, under the 1992 Regulations, activities carried on by a hybrid entity in its country of organization can rise to the level of a foreign branch separate unit distinct from the hybrid entity separate unit. See, e.g., LTR 200726019 (Mar. 28, 2007) (applying the Reg. §1.1503-2(g)(2) (vi)(C) exception to the annual certification requirement to same-country trade or business activities carried on by a hybrid entity separate unit).

⁹ See also, REG-102144-04, 70 FR 29,871, discussing the combination rule under the 2005 proposed DCL regulations.

¹⁰ See Reg. §1.1503-2(c)(15)(ii), providing that a loss, expense or deduction taken into account in computing a DCL is generally deemed to offset income of another person under the income tax laws of a foreign country in the year it is made available for such offset. The fact that the other person does not have sufficient income in that year to benefit from the offset is not taken into account. However, where the laws of a foreign country provide an election that would enable loss offset, the losses, expenses or deductions are considered to offset another person's income only if the election is made. The 2007 Regulations adopt a similar definition of "availability for use," as well as a similar exception when an election is required under local law. See Reg.

§1.1503(d)-3(b) and 1.1503(d)-3(c)(2).

¹¹ See Reg. §1.1503(d)-1(b)(4)(ii).

¹² Reg. §1.1503(d)-1(b)(4)(ii). As the preamble to the 2007 Regulations explains: "[t]he IRS and Treasury Department believe that combining same-country separate units of domestic corporations that are members of the same consolidated group is consistent with the policies of section 1503(d) because, in general, all of the items of income, gain, deduction and loss of such combined separate units will be taken into account in both the United States and the foreign country. Therefore, these final regulations expand the combination rule to apply to same-country separate units of multiple domestic corporations that are members of the same consolidated group." T.D. 9315, IRB 2007-15, 891; 72 FR 12,903.

¹³ See, e.g., Reg. §§1.1503(d)-4(d)(2)(iii)(A), 1.1503(d)-5(c)(4)(ii), 1.1503(d)-5(g)(3).

¹⁴ See T.D. 9315, IRB 2007-15, 891; 72 FR 12,903.

¹⁵ This example is based on Reg. §1.1503(d)-7(c), Example 1.

¹⁶ Because DRC is a dual resident corporation, it is not combined and treated as part of this combined separate unit and, as a result, DRC's income or DCL is not taken into account in determining the income or DCL of the combined separate unit. In addition, P's interest in DE1 is not combined and is another separate unit because it is subject to tax in Country Y, rather than Country X.

¹⁷ See, e.g., Reg. §1.1503-2(g)(2)(iii)(A)(1).

¹⁸ But see ILM 2008-10-023 (Mar. 7, 2008), applying a foreign use rule consistent with the 2007 Regulations for purposes of the 1992 Regulations.

¹⁹ The 2007 Regulations include a specific provision defining when an "indirect foreign use" occurs, Reg. §1.1503(d)-3(a)(2). As described in the preamble to the 2007 Regulations, the indirect use rules are intended "to address transactions that are structured to avoid the application of section 1503(d)." Thus, the indirect use provisions target "situations in which taxpayers have engaged in transactions

which have the effect of transferring an item of deduction or loss composing a dual consolidated loss to another entity for foreign tax purposes, so that it is made available to offset the income of a foreign corporation or the owner of an interest in an entity which is not a separate unit." T.D. 9315, IRB 2007-15, 891; 72 FR 12,902, 12,905–906. Indirect foreign use transactions generally include transactions between disregarded entities and transactions involving instruments treated as debt for foreign tax purposes and equity for U.S. federal income tax purposes. See Reg. §§1.1503(d)-3(a)(2) and 1.1503(d)-7(c), Examples 6 through 8.

²⁰ REG-102144-04, 70 FR 29,868.

²¹ REG-102144-04, 70 FR 29,868, 29872.

²² This example is based on Reg. §1.1503(d)-7(c), Example 6. See also Reg. §1.1503(d)-7(c), Example 7 and Examples 9–10.

²³ Note that a foreign use of a DCL can occur regardless of whether it actually offsets income under foreign law, so long as it is made available for such offset. Thus, in the example, a foreign use arises regardless of whether RH1 recognizes an item of income in year 1. See Reg. §1.1503(d)-3(b) and Reg. §1.1503(d)-7(c), Example 5(ii). See also REG-102144-04, 70 FR 29,868, 29872–873.

²⁴ See REG-102144-04, 70 FR 29,868, 29,872–73.

²⁵ Reg. §1.1503(d)-3(c)(9) further provides that "Such guidance may also modify the triggering events and rebuttals described in §1.1503(d)-6(e), and the exceptions thereto under Treas. Reg. §1.1503(d)-6(f), as appropriate."

²⁶ T.D. 9315, IRB 2007-15, 891; 72 FR 12,903, 12,906.

²⁷ Reg. §1.1503(d)-3(c)(4).

²⁸ Reg. §1.1503(d)-3(c)(4)(iii).

²⁹ Reg. §1.1503(d)-3(c)(4)(iii) and (c)(5)(ii).

³⁰ Reg. §1.1503(d)-3(c)(5)(iii).

³¹ *Id.*

³² *Id.*

³³ See also, Reg. §1.1503(d)-7(c), Examples 13 and 14.

³⁴ See also Reg. §1.1503(d)-7(c), Example 14.

³⁵ Reg. §1.1503(d)-3(c)(5).

³⁶ The proposed regulations did include a pre-

decessor version of the (c)(4) exception. See

Proposed Reg. §1.1503(d)-1(b)(14)(iii)(C).

³⁷ See Reg. §1.1503(d)-1(b)(4)(ii).

³⁸ See Reg. §1.1503(d)-6(d).

³⁹ See Reg. §1.1503(d)-3(c)(4).

⁴⁰ See Reg. §1.1503(d)-1(b)(4)(ii), discussed above.

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