US Outbound Tax Newsalert

A Washington National Tax Services (WNTS) Publication

August 31, 2011

IRS issues AM 2011-002 addressing interaction of dual consolidated losses and SRLY rules

Overview

The IRS Office of Chief Counsel has addressed whether a dual consolidated loss ("DCL") incurred by a hybrid entity separate unit may be taken into account in determining U.S. consolidated taxable income ("CTI") in the taxable year in which the DCL was incurred absent a domestic use election, in a generic legal advice memorandum (AM 2011-002) issued on August 1, 2011. The AM concludes that in a fact pattern where the separate unit incurs a DCL in a tax year in which it has a positive SRLY Cumulative Register (and the consolidated group has positive income), the DCL incurred by the separate unit may be used on a current basis without entering into a domestic use election.

Facts

USP is a domestic corporation and the common parent of a consolidated group. USP owns USS, a domestic corporation and member of the USP Group. USS owns 100 percent of the interests in FEX. FEX is organized under the laws of Country X, is subject to Country X income tax on its worldwide income, and is treated as a disregarded entity for U.S. federal income tax purposes.

USS's interest in FEX constitutes a hybrid entity separate unit under Treas. Reg. § 1.1503(d)-1(b)(4)(i)(B), and USS's indirect interest in its share of the business operations conducted by FEX constitutes a foreign branch separate unit under Treas. Reg. § 1.1503(d)-1(b)(4)(i)(A). These two individual separate units are combined and treated as a single separate unit ("FEX Separate Unit").

USS has conducted business operations in Country X through the FEX Separate Unit since Year 1. In Year 1, USS generates $120x of net income that is attributable to the FEX Separate Unit. In Year 2, USS incurs a net loss of $100x that is attributable to the FEX Separate Unit. USS has no other items of income or loss for Years 1 and 2. The taxable income of the USP Group (without taking into account those items of income or loss attributable to the FEX Separate Unit) for Year 1 and Year 2 is $300x and $150x, respectively.

The $100x net loss attributable to the FEX Separate Unit in Year 2 is a DCL. The USP Group does not make a domestic use election with respect to the FEX Separate Unit's DCL, and no other exceptions in Treas. Reg. § 1.1503(d)-6 apply. Accordingly, the FEX DCL is subject to the domestic use limitation rule of Treas. Reg. § 1.1503(d)-4.

In an alternative scenario, the facts are the same as above, except that in Year 1 USS generates only $60x of net income that is attributable to the FEX Separate Unit.

General Rules

Section 1503(d) and the regulations thereunder limit the use of a DCL of a dual resident corporation ("DRC") or a separate unit. Treas. Reg. § 1.503(d)-1(b)(2) defines a DRC as a domestic corporation that is subject to the income tax of a foreign country either on its worldwide income or on a residence basis. A separate unit generally is defined under Treas. Reg. § 1.1503(d)-1(b)(4) as either a business operation outside the United States that if carried on by a U.S. person would constitute a foreign branch as defined in Treas. Reg. § 1.367(a)-6T(g)(1) or an interest in a hybrid entity (such as a disregarded entity) that is subject to the income tax of a foreign country either on its worldwide income or on a residence basis.

Pursuant to Treas. Reg. § 1.1503(d)-4(b) the domestic use of a DCL generally is not permitted. This domestic use limitation, however, does not apply if the consolidated group, unaffiliated DRC, or unaffiliated domestic owner, as the case may be, files a domestic use election pursuant to Treas. Reg. § 1.1503(d)-6(d). Alternatively, pursuant to Treas. Reg. § 1.1503(d)-6(c), the domestic use limitation does not apply if the consolidated group, unaffiliated DRC, or unaffiliated domestic owner, can demonstrate that no "foreign use" of the DCL occurred in the year in which it was incurred and that no foreign use can occur in any other year by any means. Notably, these exceptions are not available to foreign insurance companies that become DRCs pursuant to a section 953(d) election.

Thus, if the taxpayer is a section 953(d) company or if a foreign use of the DCL occurs, the DCL is subject to the general domestic use limitation. Accordingly, pursuant to Treas. Reg. §1.503(d)-4, the taxpayer is required to treat a DCL as if it were a net operating loss ("NOL") incurred in a separate return limitation year ("SRLY") subject to the SRLY provisions under Treas. Reg. § 1.1502-21(c) as modified by Treas. Reg. § 1.1503(d)-4(c). With respect to a separate unit, Treas. Reg. § 1.1503(d)-4(c)(2) (the "domestic use limitation") generally provides:

> This paragraph (c)(2) applies to a dual consolidated loss that is attributable to a separate unit. The unaffiliated domestic owner of a separate unit, or the consolidated group of an affiliated domestic owner of a separate unit, shall

> compute its taxable income (or loss) or consolidated taxable income (or loss), respectively, without taking into account those items of deduction and loss that compose the separate unit's dual consolidated loss. For this purpose, the dual consolidated loss shall be treated as composed of a pro rata portion of each item of deduction and loss of the separate unit taken into account in computing the dual consolidated loss. <u>The dual consolidated loss is subject to the limitations contained in paragraph (c)(3) of this section as if the separate unit to which the dual consolidated loss is attributable were a separate domestic corporation that filed a consolidated return with its unaffiliated domestic owner or with the consolidated group of its affiliated domestic owner, as applicable. Subject to such limitations, the dual consolidated loss may be carried over or back for use in other taxable years as a separate net operating loss carryover or carryback of the separate unit arising in the year incurred</u>. (Emphasis added).

Pursuant to Treas. Reg. § 1.1502-21(c), the consolidated group may deduct a SRLY NOL (subject to certain limitations) in computing CTI to the extent that the SRLY member has contributed to the cumulative CTI of the group during the consolidated return years (the "Cumulative Register").

Analysis

At issue in the AM was whether the FEX DCL could be taken into account in computing the USP Group's CTI in Year 2, the year the DCL was incurred. As indicated above, the USP Group did not make a domestic use election with respect to the DCL. Ordinarily, absent a domestic use election, the DCL should be subject to the SRLY limitations.

In considering whether the USP Group could use the FEX DCL, the AM suggests that the application of the SRLY rules may, in certain circumstances, allow the DCL to be used to offset income of a domestic affiliate in the year the DCL is incurred. The AM examines the domestic use limitation paragraph cited above and states that the fourth sentence (underlined above) sets forth the operative rule that subjects a DCL to the provisions of Treas. Reg. § 1.1503(d)-4(c)(3) and therefore, to the SRLY limitation of Treas. Reg. § 1.1502-21(c). According to the AM, this operative rule allows a DCL to be absorbed as an offset to income of the affiliated domestic owner in the year incurred to the extent of the separate unit's cumulative prior contributions to CTI. The fifth sentence (also underlined above) merely provides for use of the portion of the DCL, if any, that has not been currently absorbed as a SRLY carryforward or carryback.

In general, a SRLY NOL cannot be used to offset CTI in the year incurred because, by definition, the loss would have arisen in a separate return limitation year. Thus, such losses can only be used as SRLY carrybacks or carryforwards. "This practical limitation does not exist in the DCL context, however, as a DCL can arise in any year, including those years when the member is included in a consolidated group," according to the AM.

The AM further noted that Treas. Reg. § 1.1503(d)-4(c)(2) permits a consolidated group to take into account a DCL to the extent the loss would be allowable as a SRLY loss under Treas. Reg. § 1.1502-21(c). Under Treas. Reg. § 1.1503(d)-2, a domestic use is considered to occur when a consolidated group takes into account a DCL -- whether in the taxable year in which the DCL is recognized or in any other taxable year. According to the AM:

> This presumption that a domestic use first occurs in the year the DCL is recognized supports a similar construction of Treas. Reg. § 1.1503(d)-4(c). Thus, the language in Treas. Reg. § 1.1503(d)-4(c)(2) allowing carryovers or carrybacks of a DCL subject to the domestic use limitation may be interpreted as providing that a DCL may be carried back or forward to the extent that it is not used in the current year. In other words, under the SRLY rules, if a member incurs a DCL after having contributed to CTI in prior years, the DCL may be absorbed currently as an offset to income of a domestic affiliate in the year of the DCL (limited by the amount of the member's prior CTI contributions).

Importantly, the AM states:

> The DCL regulations, in describing the applicability of the SRLY limitation, do not explicitly adopt the Cumulative Register concept. However, the Cumulative Register concept predates the issuance of the final DCL regulations in 2007. Because the DCL regulations fully incorporate the SRLY limitation (except for the modifications provided in Treas. Reg. § 1.1503(d)-4(c)(3)), the Cumulative Register concept applies to DCLs made subject to the domestic use limitation.

The AM also indicates that allowing the USP Group to offset its Year 2 CTI with the FEX DCL is consistent with the underlying policies of section 1503(d) because, at the time the FEX DCL is absorbed, the separate unit has made a corresponding positive cumulative contribution to CTI, thus preventing a "double dip" in which one economic loss is used to offset two streams of income.

Accordingly, the AM concludes that the USP Group may utilize the FEX DCL in determining CTI in the tax year in which the DCL is incurred even absent a domestic use election.

Thus, for Year 2 (the year the DCL was generated), the USP Group has $50x CTI ($150x less $100x DCL) and the FEX Separate Unit Cumulative Register has $20x remaining (taxable income of $120x from Year 1 less $100x DCL in Year 2).

Under the alternative fact pattern, the USP Group may only utilize $60x of the $100x FEX DCL because the FEX Separate Unit only has $60x in its Cumulative Register. The remaining $40x of the DCL remains subject to the domestic use limitation. The AM emphasizes that a domestic use election cannot be made for the $40x of the DCL that cannot be absorbed in Year 2 on a SRLY basis. A domestic use election could only be made for the full amount of the DCL - $100x.

Observations

Significantly, the AM allows a separate unit to utilize a DCL without filing a domestic use election to the extent that the separate unit has positive income in its Cumulative Register. Thus, this AM potentially allows a separate unit (or DRC) to avoid the administrative burden of filing a domestic use election and the yearly compliance requirements, as well as the risk of triggering events during the certification period that may occur as a result of particular transactions. Following the AM, however, would require that taxpayers maintain and monitor their separate unit Cumulative Registers to mitigate the risk of violating the domestic use limitation provisions.

It remains to be seen how the conclusion reached in the AM will be interpreted when both pre-2008 DCLs and post-2007 DCLs are at issue. The AM specifically dealt with DCLs incurred post-2007 and therefore, subject to the 2007 DCL regulations (T.D. 9315, March 19, 2007). The prior DCL regulations did not contain the Separate

Unit Combination Rule, so that separate Cumulative Registers presumably would be needed for each individual hybrid entity or foreign branch separate unit that had a DCL in years subject to those regulations.

Another related issue for consideration is how far back a taxpayer must go in calculating the Cumulative Register for each separate unit. The prior DCL regulations were promulgated in 1992 and the current DCL regulations were promulgated in 2007. However, the Cumulative Register concept was first introduced in temporary regulations in 1996 (generally effective for consolidated return years beginning on or after January 1, 1997, although an earlier effective date may be applicable in some circumstances) (T.D. 8677, June 27, 1996).

The AM effectively resolves a lingering uncertainty that had arisen from the language of the regulation, which some had interpreted to allow use of the DCL (without a domestic use election) on a SRLY basis only on a carryback or carryforward basis, similar to a SRLY NOL. However, the AM is correct in that the deduction of the DCL on a current basis, under facts such as those in the AM, is consistent with the broad policy underlying section 1503(d) of not allowing an economic loss to offset two streams of income.

While technically a taxpayer may not rely upon an AM as it could a revenue ruling, the AM does reflect the considered opinion of the Chief Counsel's Office and revenue agents are expected to, and regularly do, follow them in the disposition of cases where the issues are raised.

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