DCL Separate Unit Combination And Foreign Use Rules Issues

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This report addresses technical concerns raised by the combined separate unit rule and foreign use rule, each set forth in the 2007 final dual consolidated loss regulations. It focuses on the interaction of those rules with other provisions in the regulations and provides targeted recommendations regarding areas in which policymakers could reduce uncertainty or improve the rules' operation.

Table of Contents

I. Introduction

In 2007 final dual consolidated loss (DCL) regulations were issued.[1] The 2007 regulations significantly revised and updated the existing DCL regulations, which had been issued in 1992[2] to reflect the introduction of the check-the-box entity classification regulations and to reduce burdens taxpayers experienced under the 1992 regulations.[3] While the 2007 regulations have in some respects proven less burdensome than the 1992 regulations they replaced,[4] they have raised their own set of unresolved problems. This report discusses select issues arising from two aspects of the 2007 regulations: the separate unit combination rule and the foreign use rule. The analysis and recommendations in this report are drawn largely from our experiences in applying and grappling with those rules.

Section 1503(d), enacted as part of the Tax Reform Act of 1986,[5] provides the statutory backdrop for the 1992 and 2007 regulations. The statute, as originally enacted, only applied to dual resident companies, that is, domestic corporations subject to income tax on a worldwide or residence basis in a foreign country and also in the United States. Congress's intent in enacting section 1503(d), broadly speaking, was to prevent a single economic loss incurred by a dual resident company from being used to offset two different streams of income (a so-called double dip), one for U.S. tax purposes and the other for foreign tax purposes.[6] If a dual resident company was a member of an affiliated group that filed a consolidated return (a U.S. consolidated group), it might have been able to use its net operating losses to reduce other group members' taxable income and also might have been able to use those same losses to offset income of other

[1]T.D. 9315, *Doc 2007-6728*, *2007 TNT 53-7*, *corrected by* Announcement 2007-49, 2007-1 C.B. 1300, *Doc 2007-12178*, *2007 TNT 98-7*.

[2]T.D. 8434, 1992-2 C.B. 240.

[3]72 *Fed. Reg*. 12902. The 2007 regulations also were intended to address the potential over- and under-inclusiveness of the 1992 regulations.

[4]For instance, the reduction of the DCL certification period from 15 years to five years is a significant improvement that has reduced taxpayer burdens.

[5]P.L. 99-514, section 1249(a).

[6]S. Rep. No. 99-313, at 419-421 (1986).

foreign corporations under foreign tax law, such as through a foreign consolidation regime. To preclude a double dip, the statute provides that an NOL of a dual resident company (a DCL) cannot be used to reduce the taxable income of another member of a U.S. consolidated group (that is, the DCL is subject to a domestic use limitation).[7] Congress, however, anticipated that the IRS and Treasury would issue regulations circumscribing that broad rule, exempting from the definition of a DCL losses that would not be made available to offset the income of another foreign corporation under foreign tax law.[8]

A. Application of DCL Rules to Separate Units

In 1988 Congress greatly expanded the reach of the DCL rules.[9] Recognizing that double dips could occur for losses of foreign branches of domestic corporations, it enacted section 1503(d)(3), which grants the IRS and Treasury regulatory authority to apply the DCL rules to a loss of a separate unit of a domestic corporation as if the separate unit were a corporate subsidiary of the domestic corporation. A double dip can occur for a separate unit if a loss of the unit is used for U.S. tax purposes to offset taxable income of the domestic corporation (or its U.S. consolidated group) from sources other than the separate unit and also to offset taxable income of a foreign corporation for foreign tax purposes. The loss would offset two different streams of income: first, the income earned by the domestic corporation that would be taxable for U.S. purposes, and second, the income earned by the foreign corporation that would be taxable for foreign tax purposes.

The legislative history behind the provision includes an example that clarifies the perceived problem.[10] In the example, a foreign branch of a domestic corporation incurs a net loss for U.S. and foreign income tax purposes, and foreign tax law permits the loss of the branch to offset the taxable income of a foreign corporate subsidiary owned by the domestic corporation. To the extent the branch's loss offset the taxable income of the foreign subsidiary, Congress anticipated that the loss would be treated as a DCL.[11]

B. Separate Unit Combination Rule

Congress provided no meaningful guidance on how to identify a separate unit of a domestic corporation, a threshold determination. The regulations remedy that lack of guidance. The 1992 and 2007 regulations, however, adopt very different approaches as to when foreign branch operations and interests in foreign business entities are combined and treated as a single separate unit. Under the 1992 regulations, a separate unit can take the form of (1) a foreign branch (as defined in reg. section 1.367(a)-6T(g)) owned by a corporation, either directly or indirectly through a partnership or trust[12]; (2) a partnership or trust interest itself[13]; or (3) an interest in an entity not taxable as an association for U.S. income tax purposes but subject to corporate- or entity-level income tax on a worldwide or residence basis for foreign income tax purposes (a hybrid entity).[14] Except for some foreign branches,[15] the 1992 regulations apply independently to each individual separate unit of a domestic corporation. That is, the measurement of whether a DCL exists, whether and when the DCL can be used to offset income for U.S. tax purposes, and whether a DCL previously used to offset income must be recaptured, generally is determined independently for each separate unit of a domestic corporation.

Under the 2007 regulations, a separate unit can include either a foreign branch within the meaning of reg. section 1.367(a)-6T(g)(1) (a foreign branch separate unit)[16] or an interest in a hybrid entity (a hybrid entity separate unit).[17] The 2007 regulations, in contrast to the 1992 regulations, generally require

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[7]Section 1503(d)(2)(A).

[8]Section 1503(d)(2)(B).

[9]P.L. 100-647, section 1012(u).

[10]S. Rep. No. 100-445, at 307 (1988).

[11]*Id*.

[12]Reg. section 1.1503-2(c)(3)(i)(A). Under reg. section 1.367(a)-6T(g), a foreign branch is an "integral business operation" carried on outside the United States, and whether activities rise to the level of a foreign branch is determined based on the facts and circumstances. Relevant factors include the existence of a separate set of books and records and an office or other fixed place of business used by officers or employees in carrying on business activities outside the United States. Activities that constitute a permanent establishment under a U.S. income tax treaty are deemed to constitute a foreign branch. Reg. section 1.367(a)-6T(g)(1).

[13]Reg. section 1.1503-2(c)(3)(i)(B), (C).

[14]Reg. section 1.1503-2(c)(4).

[15]The 1992 regulations effectively contain a limited combined unit rule for some foreign branches. If two or more foreign branches of a domestic corporation are located in the same foreign country and losses of each branch are made available to offset the income of the other branches under the foreign country's tax law, the branches are treated as a single separate unit. *See* reg. section 1.1503-2(c)(3)(ii). The 1992 regulations do not provide a comparable rule for any other types of separate units.

[16]Reg. section 1.1503(d)-1(b)(4)(i)(A). A business operation will not constitute a foreign branch separate unit, however, if (1) it is not carried on by the domestic owner indirectly through a hybrid entity or transparent entity, and (2) it is conducted in a country with which the United States has an income tax treaty and it does not rise to the level of a PE or is not otherwise subject to net basis taxation in the foreign country under the treaty. Reg. section 1.1503(d)-1(b)(4)(iii).

[17]Reg. section 1.1503(d)-1(b)(4)(i)(B).

most same-country individual separate units of a domestic owner to be combined and treated as a single separate unit (the combined unit rule or combined separate unit rule).[18] Under the combined unit rule, all of the individual separate units owned by a domestic owner,[19] or by multiple domestic owners that are members of a U.S. consolidated group, that are (1) located in the same country, in the case of a foreign branch separate unit, or (2) subject to income tax on their worldwide income or on a residence basis in the same country, in the case of a hybrid entity separate unit, are treated as a single separate unit (a combined separate unit).[20] Except when explicitly provided otherwise in the 2007 regulations, the individual separate units composing a combined separate unit lose their character as individual separate units, so that the DCL rules apply only to the combined separate unit as a whole.[21] Only some individual separate units of a dual resident foreign insurance company are excluded from the combined unit rule.[22]

Example 1: Combined unit rule. P and S are domestic corporations and members of a U.S. consolidated group. P owns (1) DEX, a hybrid entity organized under the laws of, and taxed on a residence basis in, Country X, carrying on its own business operations; and (2) FBX, a separate branch operation that rises to the level of a permanent establishment in Country X. S owns an interest in PRSX, a partnership that conducts operations in Country X that would rise to the level of a foreign branch if carried on by a U.S. person. PRSX is classified as a partnership for U.S. tax purposes. P's interest in DEX constitutes a hybrid entity separate unit; P's indirect interest in the Country X operations of DEX constitutes a foreign branch separate unit; P's interest in FBX constitutes a foreign branch separate unit; and S's indirect interest in PRSX's Country X operations constitutes a foreign branch separate unit. Under the combined unit rule, each of those individual separate units generally loses its status as a separate unit. Instead, they are treated as a single combined separate unit.

For many domestic owners, the combined unit rule has greatly simplified the DCL rules. One particularly beneficial aspect of combining individual separate units is that in determining whether, and the extent to which, the combined separate unit has a DCL, the tax items of the individual separate units are aggregated.[23] First, items of income, gain, deduction, and loss are attributed to the individual separate units as if they were not combined, and then the combined unit takes all those items into account to determine its overall income or DCL. The cross-netting inherent in that process can in some cases make the occurrence of a DCL less likely on a combined basis than if the individual separate units were not combined. Even if a DCL does exist, its magnitude is reduced by the positive net income of any of the individual separate units. Those benefits are analogous to the benefits of filing a consolidated U.S. corporate income tax return.

Example 2: DCL of combined separate unit. Returning to the facts of Example 1, assume that under the attribution rules (1) the foreign branch separate unit owned indirectly through DEX incurs a net loss of $100, (2) FBX incurs a net loss of $50, and (3) S's interest in PRSX has net income of $125. The combined separate unit has a DCL of $25. But for the application of the combined unit rule, P's individual separate units would have DCLs of greater magnitudes than that of the combined separate unit. Alternatively, assume that S's interest in PRSX has net income of $175. The combined separate unit has net income of $25, and the DCL rules simply do not apply.

The combined unit rule's interaction with other aspects of the DCL rules, however, is more complicated, and the 2007 regulations do not adequately address the application of some fundamental provisions to combined separate units. Part II of this report discusses some of the issues raised by the combined unit rule.

C. Foreign Use of a DCL

The concepts of a ''domestic use'' and ''foreign use'' of a DCL are central to the 2007 regulations. The DCL rules in important respects generally are agnostic on whether a DCL should be used to offset the U.S. income stream or the foreign income stream.[24] They do not allocate the use of a DCL

[18]Reg. section 1.1503(d)-1(b)(4)(ii).

[19]A domestic owner is (1) a domestic corporation that has one or more separate units or interests in a transparent entity; or (2) for a combined separate unit, a domestic corporation that has one or more individual separate units that are treated as part of the combined separate unit. Reg. section 1.1503(d)-1(b)(9).

[20]Reg. section 1.1503(d)-2(b)(4)(ii).

[21]*Id*. (''Except as specifically provided in this section or sections 1.1503(d)-2 through 1.1503(d)-8, any individual separate unit composing a combined separate unit loses its character as an individual separate unit'').

[22]*Id*.

[23]Reg. section 1.1503(d)-5(c)(4)(ii). Whether a separate unit incurs a DCL generally is determined under the income, gain, deduction, and loss attribution rules of reg. section 1.1503(d)-5. Subpart F income of a controlled foreign corporation owned through a separate unit is attributed to the separate unit if an actual dividend from that foreign corporation would have been so attributed. Reg. section 1.1503(d)-5(c)(4)(iv).

[24]In this sense, the DCL rules are distinguishable from other domestic U.S. tax regimes intended to resolve multilateral tax issues. For example, the foreign tax credit is the mechanism

(Footnote continued on next page.)

between the U.S. and a foreign jurisdiction based on nexus, source, or other principles familiar in international tax law. Rather, the guiding principle is that a taxpayer's use of a DCL to offset U.S. income is unlimited only if there is not or cannot be a foreign use of the DCL, and that principle is implemented largely through an elective regime.[25]

The starting point is the domestic use limitation rule.[26] Under the 2007 regulations, the default treatment for a DCL of a separate unit is that its use is limited to offsetting income of a domestic owner only as permitted under a modified version of the separate return limitation year (SRLY) rules.[27] Under the modified SRLY rules, a separate unit's DCL can be used to offset income of the domestic owner only to the extent that the separate unit otherwise contributes or has contributed to the taxable income of the domestic owner.[28] The premise behind applying the modified SRLY rules appears to be that as long as the aggregate items of the separate unit taken into account by the domestic owner for U.S. tax purposes do not reflect a net loss, there is no double dip.

Example 3: Domestic use limitation rule. P, a domestic owner, forms DEX on the first day of year 1. DEX is a hybrid entity organized under the laws of Country X and is taxed on a residence basis there. P's interest in DEX is a hybrid entity separate unit, and P's indirect interest in the Country X operations of DEX is a foreign branch separate unit. The combined separate unit composed of P's direct interest in DEX and its indirect interest in DEX's Country X branch operations incurs a DCL of $100 in year 1. In year 2 DEX has net income of $50 (and that is P's only item of income or loss for the year). If the default domestic use limitation rule applies, P cannot use any of DEX's year 1 DCL to offset its income in year 1. P can use $50 of the year 1 DCL to offset its income in year 2, however, under the modified SRLY rules.

There are several exceptions to the domestic use limitation rule,[29] the most significant of which is if a domestic use election is made.[30] If a domestic owner makes a domestic use election, it can currently use its separate unit's DCL to offset income for U.S. tax purposes. The election is not unlimited, however. A domestic use election generally cannot be made if a foreign use or other triggering event occurs for the DCL in the year it is incurred,[31] and subject to some exceptions and limitations, a taxpayer must recapture all or a part of a DCL for which a domestic use election is made if a foreign use or other triggering event occurs during the five-year certification period following the year in which the DCL was incurred.[32] To the extent a DCL must be recaptured, the domestic owner includes a commensurate amount in gross income and pays an interest charge,[33] and the separate unit is treated as incurring a commensurate amount of loss (the reconstituted NOL), which is then subject to the generally applicable domestic use limitation rule, in the year of recapture.[34]

The concept of a foreign use is relevant to DCLs of separate units in several ways. Although that exception is rarely available, if the domestic owner proves there is no possibility of a foreign use in any year under the foreign tax law, the domestic use limitation rule does not apply.[35] Also, because a foreign use is a triggering event,[36] if a foreign use of a DCL occurs in the year in which the DCL is incurred, the domestic owner generally is not permitted to make a domestic use election for the DCL in the first instance.[37] If a domestic owner makes a domestic use election for a DCL and a foreign use

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through which domestic U.S. tax law reduces double taxation, effectively allocating primary taxing jurisdiction between the United States and foreign countries. The income sourcing rules, expense allocation and apportionment, and section 904 rules limit the FTC to incorporate policy judgments into the allocation of taxing jurisdiction. Except for the mirror rule of reg. section 1.1503(d)-3(e), no similar judgment generally appears in the DCL rules in determining whether a DCL can and should be used to offset U.S. income.

[25]This electivity extends to the use of a DCL in the context of the mirror rule. Under an agreement entered into between the United States and a foreign country, a domestic owner would be able to elect to use a DCL in a particular year to offset income in either country but not both. Reg. section 1.503(d)-6(b). On October 6, 2006, the United Kingdom and the United States entered into such an agreement. Announcement 2006-86, 2006-2 C.B. 842, *Doc 2006-22510*, *2006 TNT 214-10*.

[26]Reg. section 1.1503(d)-4(b).

[27]Reg. section 1.1503(d)-4(c)(2), (3). The SRLY rules generally apply outside the DCL context to limit a consolidated group's use of a member's NOLs from years before the member became part of the group. *See generally* reg. section 1.1502-21(c). The rules generally permit the consolidated group to use the losses to offset consolidated taxable income only to the extent of the SRLY member's cumulative contribution to the group's consolidated taxable income.

[28]The separate unit is treated as if it were a separate domestic corporation that filed a consolidated return with its domestic owner, and the DCL is treated as a loss incurred by the separate unit in a year in which the separate unit was not consolidated with the domestic owner. Reg. section 1.1503(d)-4(c)(2), (3).

[29]Reg. section 1.1503(d)-6.

[30]Reg. section 1.1503(d)-6(d).

[31]Reg. section 1.1503(d)-6(d)(2). The 2007 regulations list nine types of triggering events for a DCL. *See* reg. section 1.1503(d)-6(e)(1)(i)-(ix).

[32]Reg. section 1.1503(d)-6(e), (h).

[33]Reg. section 1.1503(d)-6(h)(1).

[34]Reg. section 1.1503(d)-6(h)(6)(i).

[35]Reg. section 1.1503(d)-6(c).

[36]Reg. section 1.1503(d)-6(e)(1)(i).

[37]Reg. section 1.1503(d)-6(d)(2).

occurs during the five-year certification period, all or a portion of the DCL may need to be recaptured, unless a triggering event exception applies.[38] Finally, the occurrence of a triggering event can be rebutted if it is shown that it is impossible for a foreign use to occur for the DCL during the remainder of the five-year certification period.[39] In that case, no recapture is required.

Under the 2007 regulations, a foreign use of a DCL occurs (subject to specified exceptions) if any portion of a deduction or loss taken into account in computing the DCL is made available under the income tax laws of a foreign country to offset, directly or indirectly, or reduce any item of income or gain that is or would be considered under U.S. tax principles to be an item of a foreign corporation or of a direct or indirect owner of an interest in a hybrid entity, if that interest is not a separate unit.[40] That definition can be exceedingly difficult to apply in complicated cases.[41]

Example 4: Foreign use. P, a domestic corporation, wholly owns DEX, a hybrid entity separate unit taxed on a residence basis in Country X. P's indirect interest in DEX's Country X business activities constitutes a foreign branch separate unit. In addition to conducting its own business operations, DEX wholly owns an interest in FRHX, an entity organized under the law of Country X that is treated as a passthrough entity for Country X tax purposes and is classified as a foreign corporation for U.S. tax purposes (a reverse hybrid entity). The combined separate unit composed of P's interest in DEX, a hybrid entity separate unit, and its indirect interest in DEX's Country X activities, a foreign branch separate unit, is attributed a DCL of $100 in year 1. For Country X tax purposes, DEX uses items of expense taken into account in calculating the DCL to offset its share of FRHX's (a passthrough entity for Country X tax purposes) income. A foreign use of the DCL occurs because items of expense or loss that were taken into account in computing the DCL are made available for Country X tax purposes to offset income of FRHX, an entity classified as a foreign corporation for U.S. tax purposes.[42]

Example 5: Foreign use. The facts are the same as in Example 4, except that instead of owning an interest in a reverse hybrid entity, DEX owns FSX, a Country X entity classified as a corporation for both Country X and U.S. tax purposes. DEX and FSX elect to determine their Country X tax liability on a consolidated basis. Again, a foreign use would occur regarding DEX's year 1 DCL because items of expense or loss that were taken into account in computing the DCL are made available for Country X tax purposes to offset income of FSX, a foreign corporation for U.S. tax purposes.

While the 2007 regulations contain several provisions mitigating the impact of the foreign use rule,[43] such as a de minimis exception,[44] the foreign use rule is an all-or-nothing rule, in that the use of any portion of the losses or deductions that go into calculating the DCL to offset income for foreign tax purposes that gives rise to a foreign use, regardless of how small those deductions or losses are in relation to the overall DCL, gives rise to a foreign use for the entire DCL. That means seemingly innocuous timing differences between U.S. and foreign tax law, such as depreciation, accrual, or capitalization differences, can result in unexpected costly recapture, and determining whether a foreign use has occurred or can occur can require painstaking tracing of how U.S. tax attributes link to foreign tax attributes. While the 1992 regulations required the same analysis, the required exercise is clear under the 2007 regulations, and the IRS has issued informal guidance in the form of a generic legal advice memorandum that illustrates the breadth of that required exercise (the 2009 GLAM).[45]

Example 6: All-or-nothing aspect of foreign use. P, a domestic corporation, owns DEX, a hybrid entity taxed on a residence basis in Country X. P's interest in DEX constitutes a hybrid entity separate unit, and P's indirect interest in DEX's Country X business operations constitutes a foreign branch separate unit. In year 1, the combined separate unit comprised of the hybrid entity separate unit and foreign branch separate unit is attributed the following U.S. tax items:

Table 1

Sales income	$100
Depreciation expense	-$50
Interest expense	-$75
Net loss	-$25

Accordingly, in year 1, the combined separate unit incurs a DCL of $25. The only difference between Country X tax law and U.S. tax law is that $5 of DEX's depreciation expense that accrues during year 1 for U.S. tax purposes does not accrue

[38]Reg. section 1.1503(d)-6(e)(1).
[39]Reg. section 1.1503(d)-6(e)(2)(i).
[40]Reg. section 1.1503(d)-3(a)(1).
[41]The concept of an ''indirect'' foreign use can be similarly challenging. *See* reg. section 1.1503(d)-3(a)(2).
[42]*See* reg. section 1.1503(d) -7(c), Example (6)(ii) (foreign use arising from foreign reverse hybrid structure).
[43]Reg. section 1.1503(d)-3(c).
[44]Reg. section 1.1503(d)-3(c)(5).
[45]AM 2009-011, *Doc 2009-22411*, *2009 TNT 195-21*.

until year 2 for Country X tax purposes. Beginning on the first day of year 2, an election is made so that DEX and FSX, a Country X foreign corporation owned by P, determine their Country X income on a consolidated basis. A foreign use occurs for the full amount of DEX's year 1 DCL because $5 of DEX's year 1 depreciation expense is made available to offset income of FSX, a foreign corporation. That is true even though the amount of expense that can be used is less than the full amount of the DCL, and it is true regardless of whether DEX can carry forward its year 1 loss to offset income of FSX in year 2 under Country X tax law.

Part III of this report discusses issues raised in the 2009 GLAM regarding the application of the foreign use rules to separate units in the context of some inbound transactions.

II. Combined Unit Rule Issues

A. De Minimis Individual Separate Units

The combined unit rule, by its terms, mandatorily applies to all individual separate units of a domestic owner, including relatively small interests in partnerships. Thus, if a domestic owner holds a separate unit through a minority interest in a partnership, it must combine the foreign branch separate unit it owns indirectly through that partnership interest, and if the partnership constitutes a hybrid entity, the hybrid entity separate unit represented by its partnership interest, with its other individual separate units in the same foreign country. The inclusion of separate units of minority partnerships in a combined separate unit poses various compliance challenges. That is relevant for taxpayers with investments in private equity partnerships and hedge funds, which commonly are structured as partnerships for U.S. federal income tax purposes to allow noncorporate investors to obtain losses or foreign tax credits and to avoid corporate-level income tax.[46]

In many cases, a minority partner might lack access to the information needed to comply with the combined unit rule, and even if the partner does have access to that information, it may have trouble obtaining the information in a timely manner. That can make it difficult to make even the most fundamental determinations under the 2007 regulations, including whether the partnership's activities rise to the level of a foreign branch separate unit,[47] and whether and to what extent items of income, gain, deduction, and loss should be attributed to the partnership's branch operations for purposes of the DCL rules.[48] Applying the foreign branch separate unit attribution rules to foreign branch separate units not owned through hybrid entities is particularly problematic, because they require more subjective legal and factual judgments (as compared with the hybrid entity separate unit attribution rules, which generally use the items shown on the entity's books and records as the starting point).[49]

A minority partner also might be unable to timely determine if the partnership has undertaken transactions that result in a foreign use or if a triggering event occurs regarding a DCL for which a domestic use election has been made and, if so, whether that triggering event can be rebutted.[50] As examples of determinations that would require information regarding partnership activities, a triggering event can include the disposition of at least 50 percent of the gross assets of a separate unit owned through a partnership over a 12-month period,[51] and the treatment of that disposition as a triggering event can be rebutted if the domestic owner can show that the disposition did not result in a carryover under foreign tax law of the separate unit's losses, expenses, or deductions.[52] As another example, determining whether there has been a foreign use of a partnership item of deduction or loss could require comparing the U.S. tax attributes of the partnership with the foreign tax attributes, a challenging task even in a world of perfect information.

In addition to those general compliance problems, a minority partner may lack sufficient information regarding, and control over, the partnership's activities to plan properly under the DCL rules. Even if the partner has sufficient access to partnership information, it might lack, in its position as a minority partner, sufficient influence over the partnership's business and tax decisions to avoid a triggering event and DCL recapture.

[46]In some cases, private equity funds have multiple small investments in hybrid entities and foreign branch operations. Under the 2007 regulations, domestic owners are required to identify those small, indirect investments and include them in their combined separate units.

[47]*See* reg. section 1.1503(d)-1(b)(4)(i)(A).

[48]*See* reg. section 1.1503(d)-5.

[49]*Compare* reg. section 1.1503(d)-5(c)(2) *with* reg. section 1.1503(d)-5(c)(3). The foreign branch separate unit attribution rules incorporate by reference several rules used outside the DCL context to determine whether income is effectively connected with the conduct of a U.S. trade or business of a foreign person.

[50]Reg. section 1.1503(d)-6(d), (e).

[51]Reg. section 1.1503(d)-6(e)(1)(iv). *See, e.g.,* AM 2008-007, *Doc 2008-14935*, *2008 TNT 131-34* (Scenario 3, discussing de minimis exception in context of a reduction of interest arising from the liquidation of a partnership) (2008 GLAM).

[52]Reg. section 1.1503(d)-6(e)(2)(ii).

Those compliance and planning challenges involving minority partnership interests are not limited to situations in which a minority interest comprises a part of a combined separate unit, and it is unclear as a policy matter that the DCL rules should apply in the first instance to those minority interests when the domestic owner has little control over the entity.[53] We agree with other commentators that it may be appropriate to exclude separate units owned in the form of or through minority interests in partnerships and other de minimis interests from the definition of a separate unit altogether, so that the DCL rules would not apply to those interests absent an abusive fact pattern.[54] Regardless of the general treatment of minority interests under the DCL rules, however, those challenges potentially carry greater (and less justifiable) consequences in the combined separate unit context because they mandatorily affect the treatment of the entire combined separate unit, not only the individual separate unit comprised of the partnership interest.

Example 7: Combined separate unit including minority partnership interest. P, a domestic corporation, owns FBX, a Country X branch. P's interest in FBX constitutes a foreign branch separate unit. P also owns a 5 percent capital and profits interest in PRSX, a Country X hybrid entity classified as a partnership for U.S. tax purposes. P's interest in PRSX constitutes a hybrid entity separate unit, and P's indirect interest in PRSX's Country X business operations constitutes a foreign branch separate unit. In accordance with the 2007 regulations, P's individual separate units are combined into a single combined separate unit. FBX's Country X operations are significantly larger than P's share of PRSX's operations, and FBX and PRSX conduct entirely independent and unrelated businesses.

In year 1, P's Country X combined separate unit has a DCL of $100, of which $98 of the net loss is attributable to FBX, and $2 of the net loss is attributable to P's interest in PRSX. P makes a domestic use election for the DCL. Under Country X tax law, PRSX is permitted to carry forward its year 1 NOL to year 2 without having to make an election. At the beginning of year 2, an unrelated foreign corporation makes a capital contribution to PRSX, reducing P's interest in PRSX to 2.5 percent of capital and profits. The contribution to capital results in a foreign use because PRSX's year 1 loss is made available to offset income of the foreign corporation in year 2 and, therefore, constitutes a triggering event for the full $100 year 1 DCL, regardless of whether P has any control or direct involvement in the PRSX transaction.[55] There does not seem to be a strong policy rationale for requiring P to tether the DCL treatment of its branch, over which it has control, to the treatment of its minority partnership interest.

Given the lack of control that a minority partner has over partnership business decisions and the lack of timely access to the information necessary to plan under and comply with the 2007 regulations, it is unnecessarily burdensome and often harsh and arbitrary for the combined separate unit rule to include minority interests. As an alternative to excluding a minority ownership interest entirely from the DCL rules, an individual separate unit that is an interest in a hybrid entity partnership, or is owned indirectly through a partnership, in which the domestic owner has less than a 10 percent interest (or some other appropriate ownership percentage threshold indicating a minority interest) could be excluded from mandatory combination with other same-country individual separate units. The 10 percent ownership interest threshold is suggested because that threshold has been identified as appropriate for the application of the de minimis exception to the foreign use rules,[56] and because that threshold is used frequently to distinguish between significant and portfolio interests in the application of other tax rules.[57]

[53]This suggestion has been made by other practitioners. *See* comment letter from James Gannon and Irwin Halpern, Deloitte Tax LLP (Dec. 8, 2011), *Doc 2011-26729*, *2011 TNT 245-12* (recommending that de minimis ownership interests be excluded from the definition of a separate unit).

[54]*Id*. Note that this approach has been taken under the proposed section 987 regulations. *See* prop. reg. section 1.987-1(b)(1)(ii) (permitting an owner of what otherwise would be a "section 987 QBU" owned indirectly through a section 987 partnership to elect not to apply the section 987 rules if the owner owns, directly or indirectly, less than 5 percent of either the total capital or the total profits interest in the section 987 partnership).

[55]The exception to a foreign use set forth in reg. section 1.1503(d)-3(c)(4)(i) for a foreign use that arises solely from another person's ownership of an interest in a partnership or grantor trust would not apply because P's reduction in its interest in PRSX exceeds the 10 percent de minimis ceiling. Reg. section 1.1503(d)-3(c)(4)(iii), -3(c)(5)(ii)(A).

[56]Reg. section 1.1503(d)-3(c)(4)(iii), (c)(5)(i), (ii)(A). A foreign use generally is not treated as occurring as a result of a reduction in a domestic owner's interest in a separate unit, provided the percentage interest is not reduced by 10 percent or more during any 12-month period. For a DCL attributable to a combined separate unit that includes an interest in a hybrid entity partnership or hybrid entity grantor trust or a separate unit owned indirectly through a partnership or grantor trust, this rule applies to the individual separate units of the combined separate unit. Reg. section 1.1503(d)-3(c)(4)(ii).

[57]*See, e.g.*, section 871(h)(3) (portfolio interest exception inapplicable to 10 percent shareholders or partners) and section 902(a) (minimum 10 percent of voting power needed to obtain deemed paid credit).

Providing a minority exception to the combined separate unit rule would not undermine the policies of the DCL rules, particularly if the DCL rules were to continue to apply to those interests on a standalone basis. It also would be possible to apply that exclusion on an elective basis, which could limit its scope to those domestic owners that experience the informational and control difficulties described above.

B. Triggering Events and Rebuttals

Unless an exception applies,[58] a domestic owner that files a domestic use election for a DCL is required to recapture the DCL if a triggering event occurs. Broadly speaking, triggering events are transactions or events that carry significant risk of a DCL being made available for current or future foreign use. The domestic owner, however, can rebut the treatment of a transaction or event as a triggering event if it demonstrates that there can be no foreign use of the DCL during the remaining portion of the five-year certification period by any means (the general rebuttal standard).[59] Under the 2007 regulations, the general rebuttal standard can be used to rebut any type of triggering event, including a triggering event resulting from the disposition of 50 percent or more of the interests in separate unit, measured by vote or value, within a 12-month period (an interest transfer triggering event).[60] Because the general rebuttal standard requires a showing that there is no possibility of a foreign use, satisfying the standard can be difficult and often may require careful tax planning and the elimination of foreign tax attributes so that no loss, expense, or deduction that went into calculating the DCL is or will be taken into account for foreign tax purposes. Although it is theoretically possible to eliminate relevant foreign tax attributes, such as by selling assets to eliminate depreciation deductions, retaining and not transferring assets that would trigger a foreign use, or repaying debt to eliminate interest expense deductions prospectively for foreign tax purposes, that can be very difficult and often is impossible as a practical matter.[61]

In comparison to the general rebuttal standard, a special rebuttal standard applies to rebut a triggering event arising from an asset transfer (the asset rebuttal standard). A triggering event occurs if 50 percent or more of a separate unit's gross assets are sold or otherwise disposed of in either a single transaction or a series of transactions during a 12-month period (an asset transfer triggering event).[62] The treatment of that disposition as a triggering event may be rebutted under the asset rebuttal standard if the domestic owner demonstrates that the transfer of assets did not result in a carryover of the relevant separate unit's losses, expenses, and deductions to the asset transferee under the relevant foreign tax law.[63] Thus, in contrast to the general rebuttal standard, which looks to the hypothetical possibility of a foreign use, the asset rebuttal standard looks to the actual foreign tax consequences of the particular transaction being tested. The presumptive rationale behind that alternative asset rebuttal standard, which generally is easier to satisfy than the general rebuttal standard, is that asset transfers are less likely than transfers of ownership interests to result in the carryover of foreign tax attributes, including deductions and losses comprising a DCL, under foreign law. Thus, asset transfers present lower risk of a future foreign use of a DCL.

The application of the general rebuttal standard in the combined separate unit context is unclear. The all-or-nothing aspect of the foreign use rule (which is incorporated into the general rebuttal standard along with the other definitional aspects of the foreign use rule through the requirement that the domestic owner establish that there is no possibility of a foreign use) makes it exceedingly difficult to satisfy the general rebuttal standard in the combined separate unit context. The IRS and Treasury considered and rejected disaggregating a combined separate unit for purposes of determining whether a foreign use has occurred because departing from the rule would lead to substantial administrative complexity.[64]

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[58]Reg. section 1.1503(d)-6(f) (triggering event exceptions).

[59]Reg. section 1.1503(d)-6(e)(2)(i) (general rebuttal standard).

[60]Reg. section 1.1503(d)-6(e)(1)(v) (interest transfer triggering event).

[61]Some taxpayers may seek to enter into voluntary agreements with the local tax authority to relinquish tax attributes that could carry over and result in a foreign use. As with the other techniques to preclude the carryover of local tax attributes, successfully implementing this technique is not easy and, depending on the facts, may raise questions about whether future foreign taxes could be viewed as noncompulsory. *See generally* reg. section 1.901-2(a)(i), (e)(5).

[62]Reg. section 1.1503(d)-6(e)(1)(iv) (asset transfer triggering event).

[63]Reg. section 1.1503(d)-6(e)(2)(ii) (asset rebuttal standard; following an asset rebuttal, the domestic use agreement continues in effect).

[64]72 *Fed. Reg*. 12902, 12910-12911. ("A number of commentators stated that the final regulations should remove the all or nothing principle and allow for a pro-rata recapture such that, for example, the disposition of an individual separate unit, which is part of a combined separate unit, would not result in the entire recapture of the combined separate unit's dual consolidated loss, but only the portion of the loss attributable to the individual separate unit. Another commentator suggested removing the all or nothing rule and allowing a taxpayer to

(Footnote continued on next page.)

Because a combined separate unit is not disaggregated for purposes of determining whether a foreign use occurs, to meet the general rebuttal standard, it is possible that the domestic owner would need to eliminate the foreign tax attributes of all individual separate units comprising the combined separate unit, including those individual separate units being retained, which were not at all involved in the transaction, to avoid triggering a recapture of the combined separate unit's DCL.[65] That interpretation of the general rebuttal standard as it applies to combined separate units would be overly restrictive as a policy matter in the context of an interest transfer triggering event involving one or more individual separate units composing part but not all of a combined separate unit, especially for a combined separate unit composed of individual separate units in diverse businesses, when the only connections among the individual separate units is common ownership and the country where they are located or organized. An alternative approach would interpret the general rebuttal standard as applying only to the transferred individual separate units. That approach would be superior as a policy matter.

Example 8: Interest transfer triggering event. P, a domestic corporation, owns three hybrid entities that are disregarded for U.S. tax purposes: DRE1X, DRE2X, and DRE3X. Each entity is located or organized in Country X, and P's direct and indirect interests in the entities and Country X activities comprise a combined separate unit that incurs a DCL for which a domestic use election is made. P intends to sell all of its interests in DRE1X, the largest individual separate unit, in a transaction that would constitute an interest transfer triggering event but for the application of the general rebuttal standard. Accordingly, P undertakes to eliminate any foreign tax attributes of DRE1X, such as asset basis, that could result in a foreign use for the expenses, losses, or deductions taken into account in determining the combined separate unit's DCL. The general rebuttal standard can be interpreted as requiring P to eliminate the items of deduction or loss attributable to DRE2X and DRE3X to ensure that there is no possibility of a foreign use in the future, even though P has no intention to transfer its interests in DRE2X or DRE3X. That likely would be difficult or impossible to accomplish as a practical matter.

The 2007 regulations should be clarified to adopt a rebuttal standard similar to that under the asset rebuttal standard, which is based on the actual foreign tax consequences of the transaction rather than the consequences of all hypothetical future transactions. Under that approach, a domestic owner could rebut the treatment of a transaction as an interest transfer triggering event if it could demonstrate that the transfer does not result in the carryover of the relevant separate unit's losses and deductions to the transferee under the relevant foreign tax law, or if it could demonstrate that there is no possibility of a foreign use for the items of deduction or loss of the individual separate unit or units in which interests are being transferred. Returning to the facts of Example 8, if a standard similar to the asset rebuttal standard applied, P could rebut the treatment of the sale as an interest transfer triggering event by eliminating only the foreign tax attributes of DRE1X, the entity involved in the transaction.[66] That would not open the door to abuse because the combined separate unit's DCL would continue to be subject to the generally applicable triggering event and other rules, as they apply to the retained interests in DRE2X and DRE3X.

That approach would make sense as a policy matter. The presumptive rationale behind applying the less restrictive asset rebuttal standard to asset transfers — that an asset transfer is less likely than a transfer of ownership interests to result in a future foreign use because it is less likely for foreign tax attributes to carry over — also applies to interest transfers involving combined separate units. A combined separate unit, as an amalgam of individual separate units, is a U.S. tax fiction that in most cases will not have its own tax attributes under foreign law. The transfer of interests in one individual separate unit of a combined separate unit ordinarily will not result in the carryover or foreign use of foreign tax attributes associated with the other individual separate units of the combined separate unit. Because there is minimal risk that a transfer of interests in an individual separate unit would trigger the carryover or foreign use of foreign tax attributes of the other individual separate units that are not being transferred, it is appropriate to apply

establish that the losses otherwise subject to recapture were not, in fact, used under foreign law. The commentator suggested that any concerns regarding an analysis of foreign law could be mitigated by requiring the taxpayer to provide certified copies of foreign tax returns and, in addition, where the foreign tax base differs substantially from the U.S. tax base, by adopting an apportionment methodology. The IRS and Treasury Department continue to believe that, even under the approaches suggested by these commentators, departing from the all or nothing principle would lead to substantial administrative complexity. As a result, these comments are not adopted'').

[65]Reg. section 1.1503(d)-6(e)(1)(v), (e)(2)(i).

[66]*See* Gannon and Halpern, *supra* note 53 (recommending that to the extent the combined separate unit rule is retained, DCL recapture be done on an individual separate unit basis rather than a combined unit basis).

a rebuttal standard based on the actual foreign tax consequences of the transaction, similar to the asset rebuttal standard.

Even if that clarification is not adopted, additional guidance is still needed on how the interest transfer triggering event rule generally applies to combined separate units. The 50 percent threshold for applying the rule is measured by voting power or value, as compared to the domestic owner's ownership percentage on the last day of the tax year during which the DCL was incurred.[67] There is no identifiable interest in a combined separate unit. There are interests only in the individual separate units that compose the combined separate unit. To the extent the rule applies to the individual separate units on an aggregate basis (that is, to the combined separate unit), the concept of voting power is inapposite because a combined separate unit, which does not exist for local corporate law purposes, lacks any identifiable shareholders, directors, or managers, and an ownership interest in an individual separate unit does not confer the holder any control rights regarding the other individual separate units of the combined separate unit.

While applying the interest transfer triggering event rule exclusively on the basis of value rather than voting power could work technically, it would not further the policy underlying the rule. Transferring 50 percent or more of the interests in a combined separate unit, however the interests are measured, does not indicate that foreign tax attributes carry over, because the combined separate unit itself does not have foreign tax attributes. From a policy perspective, the interest transfer triggering event rule makes more sense when it is applied on an individual separate unit basis because it is the individual separate units that actually have foreign tax attributes that could carry over. The application of other triggering events, such as the conversion of a separate unit into a foreign corporation,[68] is similarly uncertain in the context of a combined separate unit.

These observations illustrate a broader point: The foreign use, triggering event, and rebuttal rules are not perfectly coordinated with the combined separate unit rule. The rules need to be revisited to address their interaction. When it does not make sense to apply triggering events to a combined separate unit, the triggering event rules should either be applied to the individual separate units comprising the combined separate unit on an individual separate unit-basis or turned off entirely, and the rebuttal rules should be made less restrictive. They should apply on an individual separate unit-basis (including that only the portion of the combined unit's DCL attributable to the individual separate unit would be subject to potential recapture), to reflect that the existence of a combined separate unit is a U.S. tax fiction with no foreign tax relevance.

C. De Minimis Exception

The 2007 regulations provide exceptions to the definition of a foreign use, including exceptions for cases when the potential for foreign use is de minimis.[69] Under the de minimis exception, a foreign use is not considered to occur if an item of deduction or loss composing part of a DCL is made available to offset income under foreign tax law solely as a result of a reduction in the domestic owner's interest in the separate unit. The exception applies, however, only if (1) the domestic owner's interest is not reduced by 10 percent or more during any 12-month period, and (2) the domestic owner's percentage interest is not reduced by 30 percent or more, as determined by reference to its percentage interest at the end of the tax year in which the DCL was incurred. That exception can apply to reductions from sales, exchanges, contributions, or any other kinds of transfers and transactions.

Example 9: De minimis exception. P, a domestic corporation, owns a 50 percent interest in the capital and profits of a Country X partnership, PRSX, which also is classified as a partnership for U.S. tax purposes. P's indirect interest in the Country X operations of PRSX is a foreign branch separate unit, and the separate unit incurs a DCL for which a domestic use election is made. P sells 4 percent of the capital and profits interests in PRSX to an unrelated foreign corporation, such that P's capital and profits interest is reduced to 46 percent. The 8 percent reduction in P's interest in PRSX from the sale, considered alone, falls within the de minimis exception and therefore does not constitute a foreign use even though the separate unit's items of expense, deduction, or loss might be used to offset income of the acquiring foreign corporation under foreign tax law.

The IRS has provided informal guidance on the application of the de minimis exception in the context of a combined separate unit.[70] Like the combined unit rule, the de minimis exception is intended to benefit taxpayers, because it allows the

[67]Reg. section 1.1503(d)-6(e)(1)(v).
[68]Reg. section 1.1503(d)-6(e)(1)(vi).

[69]Reg. section 1.1503(d)-3(c)(4)(iii), (c)(5)(i), (ii).
[70]2009 GLAM (discussing application of the de minimis exception in context of multiple transfers of same interest); 2008 GLAM (discussing application of the de minimis exception in the context of a partnership).

disposition of small interests in separate units without triggering a recapture of a DCL for which a domestic use election has been made. For combined separate units composed of individual separate units engaged in unrelated trades or businesses, the de minimis exception may allow for the disposition of an entire individual separate unit without causing a recapture of the combined separate unit's DCL, as long as the disposed of individual separate unit is sufficiently small relative to the aggregate combined separate unit. That result is consistent with the general policy of the combined unit rule to treat a combined separate unit as a unified whole and cause the individual separate units comprising the whole to lose their character as separate units for purposes of the DCL rules.[71]

As illustrated by the informal IRS guidance, the application of the de minimis exception is not entirely clear in the context of a combined separate unit, and additional guidance would be beneficial. If a domestic owner disposes of interests in an individual separate unit of a combined separate unit in a transaction that falls under the 10 percent de minimis ceiling, it is unclear whether the disposed of interests are thereafter taken into account for purposes of applying the foreign use rules to the combined separate unit for future dispositions of different interests.

In the 2009 GLAM, the IRS concluded that the de minimis exception applies to a subsequent transfer of an interest in a combined separate unit that had previously been transferred in a transaction satisfying the de minimis exception.[72] A domestic owner transferred an interest in a separate unit in a transaction qualifying for the de minimis exception. The transferee in the first transfer later transferred that same interest in a transaction that would have resulted in a foreign use absent the application of an exception. The IRS concluded that the de minimis exception also applied to shield the later transfer, such that it did not result in a foreign use. If the interest transferred in a subsequent transaction, however, is not the same interest transferred in the initial transaction, or if it is an interest that when combined with the initial transfer would not continue to meet the de minimis exception, it is unclear how or to what extent the initially transferred de minimis interest should be taken into account in determining whether a foreign use arises.

Example 10: Multiple dispositions. A domestic owner owns five individual separate units that compose a combined separate unit, and the combined separate unit incurs a DCL for which a domestic use election is made. The domestic owner sells one of the individual separate units to an unrelated acquirer in a transaction that except for the application of the de minimis exception, would give rise to a foreign use (the initial disposition). For example, the relevant foreign tax law loss carryover rules could permit the unrelated acquirer to use deductions or losses composing the DCL to offset its post-acquisition taxable income (without requiring an election). Further assume that during the 12-month period following the initial disposition, the domestic owner's interest in the combined separate unit is reduced by 10 percent or more as a result of a subsequent transaction involving a different interest than that disposed of in the initial disposition (the subsequent disposition). The subsequent disposition, viewed alone, would not have resulted in an actual foreign use of the combined separate unit's DCL. The de minimis exception ceases to apply to the initial disposition because of the subsequent disposition.[73]

It is unclear under the 2007 regulations how the interest disposed of in the initial disposition is taken into account in determining whether the initial disposition and the subsequent disposition, considered together, trigger a foreign use and when the testing for foreign use is undertaken. It is unclear whether the foreign use test is applied as of the date of the initial disposition, when the first transfer occurred, or the subsequent disposition, when it first became clear that the de minimis exception did not apply to the series of transactions. If the initial disposition is taken into account in determining whether a foreign use has occurred and the occurrence of the foreign use is tested on the date of the initial disposition, a foreign use could occur and the domestic owner could be required to recapture the DCL if the domestic owner had not undertaken a transaction to eliminate the foreign tax deductions and losses taken into account in computing the DCL subject to recapture. That approach could create risk any time the domestic owner relies on the de minimis exception and does not anticipate a later transaction that would preclude reliance on it, including a transaction that might not directly involve

[71]Reg. section 1.1503(d)-1(b)(4)(ii). *See also* 2008 GLAM, Scenario 3.

[72]2009 GLAM, Scenario 2 (foreign use not deemed to arise when deduction or loss composing DCL is made available solely as a result of a de minimis reduction in the domestic owner's interest in the combined separate unit).

[73]Reg. section 1.1503(d)-3(c)(5)(ii)(A). The de minimis exception also would not apply to the initial disposition and subsequent disposition if, as a result of the subsequent disposition, the domestic owner's overall interest in the combined separate unit is reduced by 30 percent or more at any time. Reg. section 1.1503(d)-3(c)(5)(ii)(B).

the domestic owner or over which the domestic owner might have little or no control.

In contrast, if the occurrence of a foreign use is tested as of the date of the subsequent disposition, when it first becomes clear that the initial disposition does not qualify for the de minimis exception, the domestic owner may be able to undertake restructuring transactions between the time of the initial disposition and the subsequent disposition to eliminate the relevant foreign tax attributes (deductions, losses, basis, etc.) taken into account in computing the DCL and avoid a foreign use. Alternatively, it is possible that in the period between the initial and subsequent dispositions, the potentially relevant attributes will already have been fully used for foreign tax purposes under the normal operation of foreign tax law, so that no foreign use can occur after the time of the subsequent disposition. Thus, testing for a foreign use as of the date of the subsequent disposition would be taxpayer-favorable. It also would give full effect to the policy behind treating the initial disposition as not giving rise to a foreign use until the de minimis threshold is exceeded.

Analogous rules in the 2007 regulations lend support to testing for a foreign use on the date of the subsequent disposition. A foreign use generally is deemed not to occur if the foreign use results solely from another person's ownership of an interest in a partnership or grantor trust and the allocation or carryforward of an item of deduction or loss composing the DCL as a result of that ownership.[74] That exception does not apply, however, if there is more than a de minimis reduction in the domestic owner's interest in the partnership or grantor trust (applying the rules of the de minimis exception).[75] If the exception ceases to apply because the de minimis ceiling is exceeded, the provision makes clear that the foreign use is deemed to occur when the reduction in interest exceeds the de minimis amount, not at an earlier time, such as when the item of deduction or loss first became available to offset income of a foreign corporation.[76]

The 2007 regulations should be clarified so that consistent with that rule, for multiple transfers of interests in a combined separate unit, testing for a foreign use is generally done when the de minimis exception becomes unavailable. Under that approach, if a previous transaction would qualify for the de minimis exception but for the occurrence of a subsequent transaction, whether a foreign use occurs would be determined at the time of the subsequent transfer and not at the time of the de minimis initial transfer. That would allow a domestic owner to plan out of a foreign use once it anticipates that a future transaction could render the de minimis exception unavailable to a prior transaction. That issue is most relevant in the internal restructuring context because the domestic owner and the acquirer in the initial disposition would be under common control, and efforts to eliminate foreign tax attributes could be coordinated during the interim between the initial and subsequent dispositions. If the de minimis interest is transferred to an unrelated person in the initial disposition, testing for foreign use at the time of the subsequent disposition likely would be less beneficial to the domestic owner, other than in the unlikely scenario that the domestic owner previously had agreed with the unrelated acquirer that it could require the acquirer to undertake or participate in restructuring transactions that eliminate the foreign tax attributes relating to the de minimis transferred interest after the closing of the initial disposition.

Also, perhaps the 2007 regulations could be clarified such that the actual foreign use of an individual separate unit's deductions and losses arising because of a transaction covered by the de minimis exception is not taken into account in determining whether a foreign use arises in a subsequent transaction involving the same or different interest. Returning to the facts of Example 10, under that approach, if no actual foreign use arises from the transfer of the interest in the subsequent disposition, no triggering event would arise for the combined separate unit's DCL, even if the initial disposition would have given rise to a foreign use but for the application of the de minimis exception. That is, the de minimis exception would continue to shield the initial disposition until a subsequent disposition occurs that would result in an actual foreign use.[77]

That suggestion may appear to be inconsistent with the literal limitations on the de minimis exception, since the de minimis exception ceases to apply as a result of the subsequent disposition. Given the policy decision to permit actual foreign use for de minimis transfers, however, retroactively reversing that treatment in the event of a subsequent transaction that itself does not result in an actual foreign use seems inappropriate because the subsequent transaction does not increase the risk of an actual

[74] Reg. section 1.1503(d)-3(c)(4)(i). But for the application of this exception, the foreign use rule would apply very harshly for separate units owned in the form of, or through, partnership interests.

[75] Reg. section 1.1503(d)-3(c)(4)(iii).

[76] *Id*.

[77] *Cf*. Gannon and Halpern, *supra* note 53 (recommending a revision of the de minimis rules to consider only interest or asset transfers that give rise to a foreign use).

foreign use, either for the initial disposition or more generally. That is especially true for a combined separate unit when decisions to dispose of its individual separate units could be made independently of each other but could have a material effect on the domestic owner's obligation to recapture the combined separate unit's DCL.

D. Application of Modified SRLY Rules

The 2007 regulations, like the 1992 regulations, provide that the SRLY rules apply on a modified basis to DCLs to which the domestic use limitation rule applies and also apply to reconstituted NOLs arising from the recapture of DCLs for which domestic use elections were made.[78] Outside the DCL context, the SRLY rules apply to limit a U.S. consolidated group's ability to use a group member's NOL incurred in a year in which it was not a member of the group to that member's cumulative contribution to the group's consolidated taxable income. Under the domestic use limitation rules, the modified SRLY rules permit a domestic owner to use a DCL incurred by a separate unit only to the extent of that separate unit's historical net income contribution to the taxable income of the domestic owner (that is, the separate unit's positive cumulative register), determined by applying the 2007 regulation's generally applicable attribution rules.[79]

Questions have arisen regarding the application of the modified SRLY rules, including whether a domestic owner could use a DCL to offset current-year taxable income,[80] and the application of the modified SRLY rules to combined separate units. The IRS recently issued a generic legal advice memorandum clarifying that a current-year DCL may be used to offset current-year taxable income (2011 GLAM).[81] The 2011 GLAM concludes that if a separate unit incurs a DCL after having contributed to the domestic owner's taxable income in prior years, the DCL may be used currently as an offset to income of domestic affiliates in the year of the DCL without the need to file a domestic use election, limited by the separate unit's cumulative register.[82]

Example 11: Current-year DCL use. P, a domestic corporation, owns FBX, a Country X foreign branch separate unit. In years 1 through 3, FBX is attributed net income or loss as follows:

Table 2

Year	Net Income/(Loss)
Year 1	$50
Year 2	$75
Year 3	($100)

FBX's cumulative SRLY register from years 1 and 2 is $125. Under the 2011 GLAM, because that amount exceeds FBX's year 3 DCL of $100, P can fully use the year 3 DCL to offset its year 3 taxable income without making a domestic use election.

The 2011 GLAM also provides that if the separate unit's cumulative register is insufficient to offset the current-year DCL, the domestic owner can either (1) file a domestic use election for the entire DCL, or (2) offset current-year taxable income to the extent of the separate unit's cumulative register, with the remainder of the DCL being subject to the domestic use limitation rule. The 2011 GLAM notes, however, that a domestic owner cannot do both. That is, a domestic owner cannot reduce current-year taxable income to the extent of the separate unit's cumulative register and file a domestic use election for only the remaining portion of the DCL.[83]

Example 12: Current-year DCL use. Assume the same facts as in Example 11, except that FBX's year 3 DCL is $150. Under the 2011 GLAM, P could either use $125 of the year 3 DCL to offset its year 3 taxable income without making a domestic use election or use the full year 3 DCL of $150 by making a domestic use election for the full amount. P could not, however, use $125 of the DCL to offset year 3 taxable income without making a domestic use election and then make a domestic use election for the remaining $25.

The practical effect of that interpretation is tempered by the fact that if the domestic owner files a domestic use election for the full DCL and is later

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[78]Reg. sections 1.1502-21(c), 1.1503(d)-4(a), -6(h)(6)(i).

[79]*See generally* reg. section 1.1503(d)-4(c)(3).

[80]*See, e.g.*, Amy S. Elliott, "SRLY Rules Allow Favorable Usage of Dual Consolidated Losses, IRS Official Says," *Tax Notes*, Oct. 4, 2010, p. 54, *Doc 2010-20928*, or *2010 TNT 186-3*.

[81]AM 2011-002, *Doc 2011-17068*, *2011 TNT 152-18*. The rules apply to affiliated and unaffiliated domestic owners. *Id*. at 5 n.9. For a discussion of the 2011 GLAM, see Douglas Holland and Guy A. Bracuti, "AM 2011-002: A DCL Carryover That Arrives Without Traveling," *Tax Notes*, Oct. 10, 2011, p. 202, *Doc 2011-19519*, or *2011 TNT 198-8*.

[82]While not explicitly stated, a separate unit's cumulative register appears to first begin in tax years beginning on or after January 1, 1997. 2011 GLAM at 6 and n.12 (noting that the 2007 regulations fully incorporate the SRLY limitation, as modified, including the cumulative register concept applicable for consolidated return years beginning on or after January 1, 1997).

[83]The 2011 GLAM cites reg. section 1.1503(d)-1(b)(5)(ii), defining a DCL as the net loss attributable to a separate unit, in support of this conclusion. In the 2011 GLAM's alternative situation, the separate unit's cumulative SRLY register of $60 only partially offsets the current-year DCL of $100. In this case, the 2011 GLAM provides that the domestic owner either may file a domestic use election for the entire DCL of $100 or apply the cumulative SRLY register of $60 to reduce the DCL to $40. In the latter case, the domestic use limitation rule would apply to the $40 DCL and no domestic use election could be made to permit the use of that DCL in the current year.

required to recapture the DCL, the domestic owner may be entitled to offset the recapture amount by the separate unit's cumulative register.[84] In that event, the domestic owner would have benefited from the separate unit's cumulative register, albeit at the cost of an interest charge.[85] Despite the IRS's position in the 2011 GLAM, the IRS and Treasury should consider revising the 2007 regulations to clarify that a domestic owner could both use the cumulative register and make a domestic use election for the portion of the DCL remaining after application of the separate unit's cumulative register. There does not appear to be a strong policy rationale in support of that restrictive aspect of the 2011 GLAM's analysis.

Questions remain regarding applying the SRLY rules to combined separate units. Certain individual separate units may have histories of net income and others may have histories of net losses. Combining the cumulative registers of individual separate units comprising a combined separate unit for purposes of determining the combined separate unit's cumulative register appears appropriate in cases of individual separate units that have always been owned by an unaffiliated domestic owner or that have always been owned by affiliated domestic owners that have been part of the same U.S. consolidated group.

One potential issue is whether the histories of individual separate units arising in periods before the effective date of the 2007 regulations are combined for purposes of applying the SRLY rules to a combined separate unit. Most combined separate units came into "existence" as of the effective date of the 2007 regulations because the 2007 regulations substantially broadened the concept of a combined separate unit. Nonetheless, there does not appear to be a policy rationale for eliminating the pre-effective date histories of individual separate units comprising a combined separate unit. A combined separate unit should not be viewed as an entirely new separate unit but a consolidation of pre-existing individual separate units. Also, we are not aware of any suggestion in the 2007 regulations or its preamble that the SRLY history of individual separate units should start anew or that such a result should arise in respect of a combined separate unit because individual separate units lose their character as such when they join a combined separate unit.[86]

[84]2011 GLAM at 8 n.18.

[85]Reg. section 1.1503(d)-6(h)(1)(ii).

[86]Reg. section 1.1503(d)-1(b)(4)(ii). As noted in the text, we do not read this provision as creating a new separate unit, but rather, as consolidating pre-existing individual separate units.

Example 13: Cumulative register of combined separate unit. P and S, domestic corporations that are members of a U.S. consolidated group, own FB1X and FB2X, Country X foreign branch separate units that are treated as a combined separate unit. Throughout FB1X and FB2X's existences, including periods before the effective date of the 2007 regulations, P and S have been members of the same U.S. consolidated group. In 2006 through 2008, FB1X and FB2X have been attributed net income or loss as follows:

Table 3

Year	FB1X Net Income/ (Loss)	FB2X Net Income/ (Loss)	Combined Separate Unit Net Income/ (Loss)
2006	$150	($25)	$125
2007	($75)	$75	$0
2008	($50)	($50)	($100)

Because P and S were members of the same consolidated group throughout the entire relevant period so that FB1X and FB2X comprised a combined separate unit, it seems appropriate to aggregate FB1X and FB2X's cumulative registers to determine the combined separate unit's cumulative register (positive $125 as of 2008). Accordingly, P and S should be able to use the full $100 of the combined separate unit's 2008 DCL.

The proper treatment of the histories of individual separate units comprising a combined separate unit is less clear in other situations. One issue, for example, is whether the positive cumulative register of an individual separate unit of an unaffiliated domestic owner that joins a consolidated group should be added to the combined separate unit's cumulative register. If the individual separate unit of the unaffiliated domestic owner has a history of income, the unit's positive cumulative register would have permitted the unaffiliated domestic owner to offset hypothetical future losses of the separate unit under the modified SRLY rules. This is an underlying policy argument for preserving the positive cumulative register, when the individual separate unit becomes a part of a combined separate unit. The nature of the transaction involving the unaffiliated domestic owner could affect the analysis, however.

The 2007 regulations provide guidance on the treatment of a DCL of a separate unit where the separate unit loses its status as a separate unit or where the separate unit is transferred to another domestic owner. These rules governing the carryover of DCLs provide guidance in the cumulative register context by analogy. It seems reasonable to conclude that for transactions in which a DCL itself is preserved, the surrounding DCL attributes including the individual separate unit's cumulative register similarly should be preserved.

In general, a DCL of a separate unit is eliminated when the separate unit ceases to be a separate unit of the domestic owner, or in the case of an affiliated domestic owner, ceases to be a separate unit of any member of the affiliated domestic owner's consolidated group.[87] If, however, the domestic owner transfers its assets to another domestic corporation in a section 381(a) transaction and the transferee, or a member of the transferee's U.S. consolidated group, becomes a domestic owner of the transferred separate unit immediately after the transfer, the DCL attributable to the separate unit is not eliminated.[88] In those cases, income of the transferee or a member of the transferee's U.S. consolidated group that is attributable to the transferred separate unit may be offset by the inherited DCL, subject to the domestic use limitation and modified SRLY rules, as if the transferee incurred the DCL and such loss was attributable to the separate unit.[89] Outside of these enumerated transactions, however, DCLs subject domestic use limitations are eliminated and can never be used.[90]

At a minimum, we believe the cumulative register of a separate unit should carry over in a transaction for which a DCL subject to the domestic use limitation rule would carry over. Thus, for example, the positive cumulative register of an individual separate unit of an unaffiliated domestic owner that joins a U.S. consolidated group should be added to the cumulative register of the group's combined separate unit if a DCL of the transferred separate unit would have carried over to the transferee.[91] The carryover of a separate unit's cumulative register in other transactions raises difficult policy considerations, however, and guidance would be helpful.

The foregoing discussion has focused on acquisitive rather than divisive transactions. Similar issues regarding the cumulative register of an individual separate unit composing part of a combined separate unit are raised when the affiliated domestic owner of an individual separate unit leaves its U.S. consolidated group, so that the individual separate unit ceases to be a part of a combined separate unit owned by members of the group. One question is whether the history of the individual separate unit should follow the separate unit or alternatively should remain with the combined separate unit.

Again, the rules governing the carryover treatment of DCLs in divisive transactions provide guidance by analogy. If an individual separate unit loses its status as a member of a combined separate unit because its affiliated domestic owner ceases to be a member of a consolidated group, or because there is a transaction that causes the individual separate unit to leave the combined separate unit (for example, through a sale), the portion of the DCL of the combined separate unit attributable to the individual separate unit can carry over to the domestic owner, and the portion of the DCL attributable to the remaining individual separate units comprising the combined separate unit is retained by the consolidated group and remains subject to the domestic use limitation.[92]

This treatment suggest that at least in some divisive transactions it could be appropriate to allocate the cumulative register of the combined separate unit between the departing individual separate unit and the remaining individual separate units comprising the combined separate unit. That is, the cumulative register of the departing individual separate unit would be allocated to that unit, and the remainder of the combined separate unit's cumulative register would remain with the combined separate unit.

III. Foreign Use Rule Issues

As explained above, a foreign use is relevant in several contexts under the 2007 regulations. If a foreign use occurs in the year a DCL is incurred, with some exceptions, the DCL is subject to the domestic use limitation (and the modified SRLY rules) and no domestic use election can be made. In effect, that means the deductions and losses comprising the DCL cannot be used for U.S. tax purposes to offset income of the domestic owner (or that of its consolidated group) except for income attributable to the separate unit.[93] Also, if a foreign use occurs during the five-year certification period for a DCL for which a domestic use election was made, the domestic owner might be required to recapture all or a portion of the DCL.[94] Although determining whether a foreign use occurs may be straightforward in simple cases, in other cases it can be extraordinarily difficult because the 2007 regulations require a review of whether and when each

[87]Reg. section 1.1503(d)-4(d)(1)(ii). *See also* reg. section 1.1503(d)-7(c), Example 21(ii).

[88]Reg. section 1.1503(d)-4(d)(2)(iii) (including combined separate units).

[89]*Id. See also* reg. section 1.1503(d)-7(c), Example 21(iii)-(v).

[90]Reg. section 1.1503(d)-4(d)(1)(i), (ii).

[91]*See* reg. section 1.1503(d)-4(d)(2)(iii).

[92]*Id. See also* reg. section 1.1503(d)-7(c), Example 21(iv) (DCL of combined separate unit apportioned between retained and disposed of individual separate units).

[93]*See* reg. section 1.1503(d)-6(d)(2), -(e)(1)(i), -2, -4.

[94]Reg. section 1.1503(d)-6(e)(1)(i).

item of deduction or loss taken into account in computing the DCL has offset or is made available to offset income of a foreign corporation for foreign tax purposes.[95]

To determine whether a foreign use occurs for a DCL, the domestic owner must (1) identify the items of expense or loss taken into account in calculating the DCL (under U.S. tax principles); and (2) determine whether each of those items of expense or loss also had been deducted for foreign tax purposes, and if not, when and by whom that item could be deducted locally, if at all. That requires the domestic owner to work with a foreign tax adviser to prepare both U.S. and foreign tax accounts to compare the deductions and losses and the timing of deducting those items. Complicated foreign tax planning could become necessary if the domestic owner has made a domestic use election for the DCL and is contemplating a transaction that could constitute a triggering event (which could be rebutted by showing there is no possibility of a foreign use of the DCL).[96] Even minor differences in the timing of the deduction for the expense or loss under U.S. federal income tax law and foreign tax law could result in a recapture of the full amount of the DCL (that is, the all-or-nothing aspect of the foreign use rules). Planning to avoid recapture could involve eliminating foreign tax attributes (for example, NOLs or depreciable basis) before the transaction, such as by selling property, extinguishing or transferring obligations, or relinquishing or using foreign tax items. In many if not most cases, that planning will be impossible because of practical limitations, such as potentially adverse business or foreign tax consequences.

For example, assume a domestic owner plans to dispose of a separate unit or a portion thereof, and the separate unit previously incurred a DCL for which a domestic use election was made. If the domestic owner is fortunate, the foreign tax deductions and losses will have accrued and been used at the same time as (or earlier than) they were for U.S. tax law purposes, so that there would be no possibility that the deductions or losses could be taken into account for foreign tax purposes in a period after the transaction. Even if the timing works out in the domestic owner's favor, however, an NOL could exist for foreign tax purposes that could be carried forward and used after the transaction. In that case, it may be necessary to extinguish that NOL by undertaking local transactions that eliminate it (for example, merging the loss company into a shell or selling built-in gain assets before the planned disposition to absorb the NOL and avoid the potential for a future foreign use of the NOL).

A. Qualifying for Nonrecognition Treatment

The IRS has highlighted the importance of identifying the connection between foreign and U.S. income tax deductions and losses in the 2009 GLAM. Most international tax practitioners are aware of the potential DCL recapture risk (along with the risks of branch loss recapture and overall foreign loss recapture)[97] involved in incorporating a foreign branch operation that previously generated losses. Generally, the incorporation of a separate unit through an entity classification change (a check-the-box election) will result in a triggering event for prior-year DCLs of the separate unit for which domestic use elections were made.[98] It is likely that fewer practitioners are aware of the obscure potential DCL risks involved in the inverse transaction — a conversion of a foreign corporation to a foreign operation that constitutes a separate unit, such as a check-the-box election converting a foreign corporation to a foreign hybrid entity.

In scenario 1 of the 2009 GLAM, the domestic owner elects to convert a foreign corporation into a disregarded entity qualifying as a hybrid entity separate unit by filing a check-the-box election in the middle of the foreign corporation's foreign tax year.[99] After the election, the separate unit incurs a loss for both U.S. and foreign tax purposes, which loss the IRS presumes is made available to offset or reduce the income of the entity before its classification change (that is, the loss is made available to offset the income of the entity when it was considered a foreign corporation for U.S. income tax purposes).

The IRS concludes that because the deductions or losses taken into account in determining the post-liquidation short-year DCL are made available to offset the income or gain of the foreign entity during the period when it was considered to be a foreign corporation for U.S. tax purposes (the period during the foreign entity's foreign tax year before the effective date of the entity classification election), a foreign use occurs. Therefore, the domestic owner cannot file a domestic use election for the DCL.[100] The 2009 GLAM further concludes in a footnote that even if the domestic owner had taken into account the foreign corporation's earnings and

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[95]Reg. section 1.1503(d)-3(a), -6(e)(2).

[96]Reg. section 1.1503(d)-6(e)(2)(i).

[97]Section 367(a)(3)(C) (branch loss recapture); section 904(f)(3) (overall foreign loss recapture).

[98]Reg. section 1.1503(d)-6(e)(1)(vi).

[99]Reg. section 301.7701-3(c).

[100]2009 GLAM, Scenario 1.

profits as a result of the liquidation,[101] that inclusion would have had no effect on the occurrence of the foreign use, nor would it have reduced or eliminated the resulting DCL recapture.[102]

Example 14: Midyear liquidation of foreign corporation. P, a domestic corporation, wholly owns FSX, a Country X entity classified as a corporation for U.S. tax purposes, which uses the calendar year as its tax year for both U.S. and foreign tax purposes. A check-the-box entity classification change is made, causing FSX to become classified as a disregarded entity effective as of July 1 of year 1. P's interest in the resulting Country X hybrid entity constitutes a hybrid entity separate unit, and its indirect interest in the Country X operations constitutes a foreign branch separate unit. During the period from July 1 to December 31 of year 1, the combined separate unit comprised of those interests is attributed a DCL of $100. Because the DCL is computed under U.S. tax principles, it is composed only of deductions and losses that accrue for U.S. tax purposes after the liquidation. Under the reasoning of the 2009 GLAM, P could not make a domestic use election for the post-liquidation short-year DCL because a portion of the expenses, losses, and deductions composing the DCL would be deemed to offset income of FSX under Country X tax law during the period from January 1 to June 30 of year 1, the period during which it was classified as a foreign corporation for U.S. tax purposes, so that a foreign use occurs.

Generally speaking, if a foreign entity always has been a separate unit or changes its classification to a foreign corporation, accelerated timing of foreign tax deductions and losses relative to the timing of U.S. tax deductions and losses generally is favorable to avoiding a foreign use, assuming those deductions are actually used and no foreign tax law NOL carryforward results. In contrast, if one believes the 2009 GLAM reaches the correct result, if a foreign entity changes its classification so that it becomes a foreign corporation, accelerated timing of local tax deductions and losses relative to the timing of U.S. tax deductions and losses actually could result in a foreign use.

In a footnote in the 2009 GLAM, the IRS cautions that even if the domestic owner had made the classification election effective for the first day of the foreign entity's local tax year, a foreign use still could arise because of differences in the timing of items of deduction or loss under U.S. and foreign tax law.[103] That could arise, for example, if depreciation deductions accrue in the short year following the liquidation under U.S. tax principles but are treated as having accrued in prior periods under foreign tax principles (that is, they were accelerated under foreign tax law) or if the loss recognized in a post-liquidation period for foreign tax purposes gives rise to an NOL that could be carried back without an election to pre-liquidation periods, when the entity had been considered a foreign corporation for U.S. income tax purposes.[104] In that case, a foreign use could be deemed to occur and a domestic use election would not be available.

Example 15: Accelerated foreign tax law deductions. Assume the same facts as in Example 14, except that the entity classification election becomes effective as of January 1 of year 2 and that the Country X separate unit resulting from the check-the-box election incurs a DCL in year 2. If the suggestion in the 2009 GLAM footnote is followed, then if any of the Country X tax analogs to the expenses or losses taken into account in determining the year 2 DCL are taken into account and used to offset income in a prior year for Country X tax purposes, a foreign use would be deemed to occur and P could not make a domestic use election. That could be the case, for example, if Country X tax law provided for accelerated depreciation or accelerated interest expense accrual relative to U.S. tax law, or if it permitted FSX to deduct expenses that were required to be capitalized under U.S. tax law.

As an initial observation, the conclusions reached in the 2009 GLAM regarding backward-looking foreign uses reflect a mechanical interpretation of the definition of a foreign use. It is not clear that the drafters of the regulations had that application in mind. Illustrating this, for all the triggering events other than a foreign use, the relevant transaction resulting in the triggering event can occur only after the separate unit has come into existence and the DCL has been incurred, and no example in the 2007 regulations involves a foreign use resulting from an event occurring before or at the same time that the separate unit and DCL come into existence. At best, the results in the 2009 GLAM represent obscure traps for the unwary, and at worst they represent questionable conclusions. If policymakers believe the 2009 GLAM reaches the right results, that should be made clear in published guidance, and

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[101]Generally, for an inbound liquidation described in section 332, the domestic corporate parent of the liquidating foreign corporation is required to take into account its all earnings and profits amount as a dividend. Reg. section 1.367(b)-3(b)(3)(i).

[102]2009 GLAM at 10 n.33.

[103]*Id.* at 10 n.34

[104]If an election were required for an NOL to be carried back, no foreign use would arise unless the election actually were made. Reg. section 1.1503(d)-3(c)(2).

the IRS should enforce the results only prospectively after the guidance has been published.

In any event, it also is not clear that the 2009 GLAM reaches the correct results, either as a policy or technical matter. The conversion of a foreign corporation to a passthrough entity, the situation addressed in the 2009 GLAM, appears less objectionable from a DCL perspective than the conversion of a passthrough entity to a foreign corporation, which generally will constitute a triggering event for DCLs for which domestic use elections were made by any separate units owned through the passthrough entity.[105] First, because the DCL is incurred after the relevant event occurs, the domestic owner would have no control over the potential occurrence of the foreign use. That raises fundamental issues of fairness to taxpayers. Second, and more substantively, when the check-the-box election results in an inbound liquidation described in section 332 (the taxable liquidation context is discussed in Part III.B), the domestic owner will have taken its earnings and profits amount into account as a deemed dividend and would be deemed to have paid the foreign income taxes carried up by the dividend.[106] Because of that dividend inclusion, deemed paid FTC, and section 78 gross-up, the domestic owner is in roughly the same U.S. tax position as if it had conducted the liquidated foreign corporation's operations through a branch during the entire time the domestic corporation owned the foreign corporation.[107] The potential foreign use would involve expenses or losses composing the DCL being used to offset income of a foreign corporation that has been taken into account by the domestic owner for U.S. tax purposes.

Stated differently, a foreign use occurs only if an item of deduction or loss is made available to offset income of a foreign corporation, as classified for U.S. tax purposes. The 2007 regulations adopt, as a guiding principle, that whether a loss impermissibly offsets two streams of income is determined under a U.S. tax lens: U.S. tax classifications apply, and the DCL is measured by taking into account only U.S. tax items. In the inbound section 332 liquidation context, the DCL would not be offsetting two different streams of income under U.S. tax principles — one of the domestic owner and the other of the foreign corporation — because those two streams would have converged and become one at the time of the liquidation, when the domestic corporation was taxed on the all earnings and profits amount.[108] Accordingly, an impermissible double dip should not be deemed to occur.

Third, the continuing impact of the foreign entity's former existence as a foreign corporation becomes less relevant over time. For instance, tax laws usually provide for significantly longer periods to carry forward losses than to carry them back, resulting in less opportunity for the deductions and losses that compose the DCL of a separate unit that had been a foreign corporation to result in a foreign use. Also, while timing differences could cause deductions or losses composing a DCL of a separate unit to be made available to offset or reduce income of the entity during the period it was classified as a foreign corporation, the timing differences could reverse well before the separate unit realizes a DCL on a stand-alone or combined unit basis.

Thus, there is a meaningful distinction between instances in which a passthrough entity becomes classified as a foreign corporation and instances in which a foreign corporation becomes a passthrough entity to create one or more separate units. When a DCL already exists, it seems more reasonable to require the domestic owner to demonstrate that the deductions and losses comprising the DCL cannot be used to offset the income of the entity when it becomes a foreign corporation. In the inverse situation, when no DCL yet exists,[109] the domestic owner should not be required to continue tracking the historic operations of the new separate unit to determine whether a future loss could have been used in the past when it had been a foreign corporation.

Finally, it is not clear that the 2009 GLAM reaches the correct technical answer. As others have noted, the 2009 GLAM raises difficult questions of how domestic owners can identify and link specific items of deduction and loss composing a DCL, which are identified and measured under U.S. tax

[105]Reg. section 1.1503(d)-6(e)(1)(vi) (triggering event arises when hybrid entity separate unit becomes a foreign corporation).

[106]Reg. section 1.367(b)-3(b)(3)(i); section 902(a).

[107]In some regards, the all earnings and profits amount may be analogous to a positive SRLY cumulative register.

[108]*See Dover v. Commissioner*, 122 T.C. 324 (2004), *Doc 2004-9660*, *2004 TNT 88-15* (concluding that in a section 381 transaction such as a section 332 liquidation, the transferee generally inherits the transferor's history for U.S. federal income tax purposes). Contrary to this view, the IRS notes in the 2009 GLAM that even if a domestic owner had taken into account for U.S. tax purposes the earnings and profits of the separate unit while it had been a foreign corporation, no domestic use election would be available. 2009 GLAM (discussion in n.33 cites the legislative history to the 1986 enactment of DCL rules covering dual resident companies and notes the lack of any policy reason to permit the use of one company's deduction by two other companies in two jurisdictions).

[109]While the separate unit's DCL arose in the post-liquidation short year in the facts of the 2009 GLAM, in other fact patterns the DCL might not arise until years later.

principles, to items of deduction or loss under foreign tax law, determinations which are relevant in testing whether a foreign use of the DCL occurs.[110] It is unclear how a domestic owner identifies the corresponding items of loss and expense for foreign tax purposes when a separate unit comes into existence because of an entity classification change (that is, a conversion of a foreign corporation to a passthrough entity) or when it undergoes a reorganization or other corporate change. The 2007 regulations do not provide meaningful guidance on the method for identifying the links.[111] The need for guidance is heightened because a domestic owner has the burden of establishing that no foreign use has arisen or could arise.[112]

As noted above, the 2009 GLAM assumes that a portion of the deductions and losses of the separate unit's DCL are available to offset the income of the entity before its classification change. For an entity classification election, which would not have foreign tax significance, the foreign entity would retain its local tax attributes and its tax year would not close or change. For U.S. tax purposes, however, the entity's tax year would end on its classification change, and in the absence of further guidance, the domestic owner would compute the separate unit's taxable income or DCL based on a closing of the books method, consistent with generally applicable U.S. tax principles. That raises but does not resolve the difficult issues of identifying the items, as viewed for foreign tax purposes, that correspond to the items of U.S. deduction and loss comprising the post-liquidation short-year DCL (given that the foreign tax items of income and expense for the entity would be shown only on its full-year foreign tax return), and determining whether a foreign use has occurred or could occur for those items.

To make those determinations, the domestic owner would need to list each item of deduction and loss taken into account in determining the post-liquidation short-year DCL and prepare a list of each similar item taken into account in determining the foreign entity's full-year local tax results. While the foreign tax law might not make clear when items of income and expense accrue during the local tax year (for example, ratably over the course of the year or discretely at the end of the year), the timing of that accrual would be critical to determining if the DCL is indeed available to offset or reduce the foreign entity's income arising before the entity classification change. The 2009 GLAM adopts a presumption that items of income and expense accrue ratably during the year under foreign income tax law. That presumption is taxpayer-unfavorable because it treats the items of deduction and loss comprising the DCL as available to offset the entity's foreign income earned before the entity classification change, during the period in which it was classified as a foreign corporation.

It is not clear that this presumption is appropriate. It does not seem practical or realistic to require the determination to depend on actual foreign tax law because in many cases the foreign tax law will be unclear, so some convention seems necessary. Any convention adopted will be to some degree arbitrary, and there does not appear to be a strong policy rationale for applying a taxpayer-unfavorable convention, such as a convention that treats income and expense as accruing ratably during the foreign entity's foreign tax year.

Rather, because the DCL rules are a U.S. tax construct, there appears to be a strong argument in support of adopting a taxpayer-favorable convention that follows generally applicable closing of the books U.S. tax principles (for example, section 381(b)(1)).[113] That would treat the portion of expenses and losses deemed to accrue for U.S. tax purposes in the pre-change period as offsetting only income earned in that period for purposes of applying the foreign use rule and treating the portion of the expenses and losses deemed to accrue in the post-change period as offsetting only income earned in that period. That convention would be more consistent with the rule in the 2007 regulations that presumes that in the absence of a definitive foreign rule, deductions and losses comprising a DCL are first made available to offset income that, when offset, does not give rise to a foreign use, before being made available to offset income that, when offset, gives rise to a foreign use.[114]

Example 16: Closing of the books convention. Return to the facts of Example 14: P, a domestic

[110]*See* John D. McDonald and Jeffrey P. Maydew, "All-or-Nothing Rule Leaves Taxpayers Empty-Handed," *Tax Notes*, Mar. 15, 2010, p. 1379, *Doc 2010-3811*, or *2010 TNT 50-8*.

[111]The regulations' examples make simplifying assumptions that are not reflective of the complex nature of actual business operations or actual differences in U.S. and foreign tax law. *See* reg. section 1.1503(d)-7(c), examples 30 and 31.

[112]This tracing analysis is precisely the analysis the IRS wanted to avoid in its adoption of the all-or-nothing rule. 72 *Fed. Reg*. 12902, 12909 (preamble explanation of why the IRS and Treasury rejected a de minimis exception and retained the all-or-nothing rule). *See* McDonald and Maydew, *supra* note 110, at 1381.

[113]Most asset reorganizations described in section 368 and liquidations described in section 332 result in the creation of a short tax year for the distributor or transferor corporation. The tax year of the distributor or transferor corporation ends on the date of the transfer or distribution. *See* section 381(b)(1).

[114]Reg. section 1.1503(d)-3(c)(3) (applying presumption when there are no applicable rules for allocating losses or deductions against income under the foreign law).

corporation, makes a check-the-box entity classification change for FSX, a foreign corporation, causing it to become classified as a disregarded entity effective as of July 1 of year 1. During the period from July 1 to December 31 of year 1, the combined separate unit comprised of P's interests in FSX is attributed a DCL. Under a closing of the books convention, no portion of the expenses, losses, and deductions taken into account in determining the post-liquidation short-year DCL would be deemed to offset income of FSX for Country X tax purposes during the pre-liquidation period. Rather, those deductions and losses would be deemed to offset only post-liquidation income of FSX, and pre-liquidation deductions and losses would be deemed to offset only pre-liquidation income.

Given those policy and technical considerations, we believe the IRS and Treasury should consider exempting that situation from the foreign use rules.[115] That is, a separate unit that had once been a foreign corporation would receive a fresh start, so that taxpayers can file domestic use elections for the separate unit's DCLs without regard to the entity's prior history as a foreign corporation. Alternatively, the 2007 regulations should be modified to allow for a closing of the books method or other reasonable method that does not automatically presume that a foreign use occurs.[116] If no exception is provided, additional guidance clarifying the application of the foreign use rules to a separate unit that had been a foreign corporation would be helpful, including guidance on the method for identifying the corresponding items of losses and expenses of the separate unit under U.S. and foreign tax law to determine whether a foreign use is deemed to occur.

B. Taxable Inbound Event

Taxable inbound transactions, such as liquidations that do not qualify under section 332, raise further considerations. In an inbound section 332 liquidation or an inbound reorganization (subject to sections 334, 337, 367(b), 368, and 381), for U.S. tax purposes, the domestic owner generally would take a carryover tax basis in the property deemed distributed or transferred by the distributor or transferor foreign corporation, and that property would be deemed owned by the newly created separate unit. In the absence of any gain or loss limitation provisions, the domestic owner likely would be able to identify the local tax counterparts for each item of deduction and loss, as viewed from a U.S. tax perspective, since the items would remain essentially intact for U.S. tax purposes. If, however, a gain or loss limitation provision applies, such as the anti-loss importation rule of section 334(b)(1)(B), the domestic owner would not necessarily succeed to the distributor or transferor foreign corporation's basis in particular assets, meaning that no link (or only a very tenuous link) may exist between the items of deduction and loss claimed for U.S. tax purposes and those claimed for foreign tax purposes in connection with the assets.

If the distributing foreign corporation liquidates in a taxable transaction, however, sections 332, 334(b), 337, and 381 would not apply. The distributing corporation would recognize gain or, subject to limitations, loss on the distributed assets, and the distributee domestic corporation would take a fair market value basis in those assets.[117]

Example 17: Taxable inbound liquidation. P, a domestic corporation, owns 55 percent of the stock of FSX, a Country X corporation, with the other 45 percent owned by an unrelated foreign corporation. A check-the-box election is filed, causing FSX to become a hybrid entity classified as a partnership for U.S. tax purposes, effective as of July 1 of year 1. The deemed liquidation is taxable for U.S. purposes: FSX recognizes any gain on its distributed assets,[118] P recognizes any gain or loss on its stock of FSX,[119] and P takes a stepped-up or stepped-down basis in the assets and is deemed to contribute the assets to a newly formed partnership.[120] During the period from July 1 to December 31 of year 1, P's Country X combined separate unit incurs a DCL.

In that case, it is unclear how P is to identify the foreign tax counterparts of FSX's items of depreciation and amortization deduction and gain or loss on the transferred assets as determined under U.S. tax principles. The historic connection between FSX's post-liquidation tax bases in its assets as viewed for U.S. tax purposes — which affect depreciation and amortization deductions and loss recognized on the assets, items that are taken into account in determining the separate unit's DCLs — is severed from the pre-liquidation foreign tax bases of FSX's assets. Because the U.S. tax bases in the transferred assets would be reset to FMV in the taxable liquidation,

[115]Exceptions could apply, however, in cases of abuse, such as when a taxpayer enters into a structure with the intent to benefit from a double dip through an entity classification change.

[116]*See* McDonald and Maydew, *supra* note 110, at 1383-1384 (reasoning that a daily accrual rule would be appropriate).

[117]*See generally* section 336. Given the taxable nature of the transaction for U.S. tax purposes but not for foreign tax purposes, however, section 901(m) could be implicated.

[118]Section 336(a).

[119]Section 331(a).

[120]Reg. section 301.7701-3(g)(1)(ii). For purposes of this example, it is assumed that the liquidation is not characterized as a section 368(a)(1)(C) or other reorganization.

the post-transaction deductions and losses on those assets may not necessarily have any foreign tax counterparts, making it difficult, if not impossible, to determine whether a foreign use has occurred involving deductions and losses relating to the transferred assets.

Because of that additional technical break in the link between U.S. and foreign tax items, for a taxable liquidation or other similar transaction, we believe that those transactions generally are outside the scope of the 2009 GLAM and should not result in potential foreign use of a DCL.[121] We also believe it would be appropriate for the IRS and Treasury to confirm that taxable transactions generally fall outside the scope of the 2009 GLAM and that the occurrence of a foreign use should be tested on a prospective basis only. That would give the domestic owner a fresh start and would avoid requiring taxpayers to construct methods for tracing the DCL's components to foreign counterparts when no workable method appears available. If this suggestion is not implemented, given the uncertainty surrounding the breadth of that aspect of the 2009 GLAM, the IRS and Treasury should consider issuing published guidance providing simplifying conventions or safe harbors to allow domestic owners to identify foreign tax counterparts to the component items of deduction and loss of a DCL and to determine when a domestic owner can cease tracing the links between the U.S. and foreign tax items.[122]

[121]Even for a taxable transaction, there could be some expenses or losses that give rise to a potential foreign use because they would not be reset or eliminated in a taxable transaction for U.S. tax purposes (*i.e.*, items of deduction or loss that are not dependent on basis differences in the distributed assets).

[122]*See* McDonald and Maydew, *supra* note 110, at 1388 (questioning how long a domestic owner needs to trace the taint of accelerated foreign tax deductions and offering potential alternatives).