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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Chief Counsel, LMSB, Heavy Manufacturing & Transportation

FROM: Michael Frankel, Senior Technician Reviewer
CC:INTL:BR4

SUBJECT:

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Legend

Taxpayer =
X1 =
X2 =
X3 =
X4 =
Y1 =
Y2 =

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Y3	=
Y4	=
PRS1	=
PRS2	=
Y5	=
Y6	=
Y7	=
Y8	=
Y9	=
Y10	=
Y11	=
PRS3	=
PRS4	=
PRS5	=
Z1	=
Z2	=
Z3	=
Z4	=
Z5	=
Z6	=
Z7	=
FC1	=
FC2	=
Property A	=
Property B	=
Property C	=
Type I	=
Type II	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Article z	=
Act1	=
cite1	=
cite2	=
cite3	=
cite4	=
cite5	=
cite6	=
cite7	=
cite8	=
cite9	=
cite10	=
cite11	=
Opinion A	=

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Opinion B	=
claim1	=
claim2	=
claim3	=
sharing company	=
receiving company	=
Group1	=

Issues

There are two issues addressed in this memorandum. First, whether Y8 qualifies as a dual resident corporation. Second, whether the Taxpayer has provided sufficient information to prove that the losses of its other entities meet the exception to the definition of a dual consolidated loss under Treas. Reg. § 1.1503-2(c)(5)(ii)(A).

Conclusions

We believe that Y8 may not be a dual resident corporation. However, you may wish to consider whether its activities in FC1 are sufficient to meet the definition of a foreign branch. If it is a foreign branch, then it is treated like a dual resident corporation. We also believe that the Taxpayer has apparently failed to meet its heavy burden to show that the losses of its other entities meet the exception to the definition of a dual consolidated loss. In order to meet this burden, the Taxpayer must provide a well reasoned and well supported analysis that supports its claim that both parts of the exception in Treas. Reg. § 1.1503-2(c)(5)(ii)(A) are met for each entity. The opinions the Taxpayer submitted to support its claim do not appear to meet this test.

Background

The Taxpayer is presently under examination for its Year 1 and Year 2 tax years. It is the common parent of an affiliated group of companies that files a consolidated return. One of the issues in the audit concerns the application of § 1503(d) to losses from foreign activities incurred by various subsidiaries of the Taxpayer and used to offset the Taxpayer's consolidated income. After the examiner raised that issue, the Taxpayer submitted a request to the national office for an extension to file agreements as described under Treas. Reg. § 1.1503-2(g)(2) that would allow use of these losses. While this request was under review, the Taxpayer also took the position that one of the entities involved was not a dual resident corporation and that the others did not have dual consolidated losses. The Taxpayer was advised that it must represent that the entities were dual resident corporations and that those entities had dual consolidated losses in order to receive the extension to file the agreements. At that point, the Taxpayer withdrew its request for the extension for all but three of the entities. As to the extension request for those remaining three entities, that was dealt with separately and therefore is not the subject of this memorandum. This memorandum reviews the Taxpayer's arguments with regard to the withdrawn entities and suggests additional information that the Taxpayer may need to provide to support those arguments.

Facts

The Taxpayer owns all of the interests in X1. X1 owns all of the interests in X2. All three are domestic corporations.

X2 owns all of the interests in X3 and X4. Both X3 and X4 are domestic corporations.

FC1 Entities

X2 owns all of the interests in Y1, Y2, Y3, and Y4. These are all domestic corporations. Y1 and Y2 each own a 50 percent interest in PRS1. Y3 and Y4 each own a 50 percent interest in PRS2. Both PRS1 and PRS2 are FC1 Corporations that are treated as partnerships for U.S. federal income tax purposes.

X3 owns all of the interests in Y5, Y6, Y7, and Y8. All of these are domestic corporations. X4 owns all the interests in Y9, Y10, and Y11. Y5 and Y9 each own a 50 percent interest in PRS3, Y6 and Y10 each own a 50 percent interest in PRS4, and Y7 and Y11 each own a 50 percent interest in PRS5. PRS3, PRS5, and PRS4 are all FC1 corporations that are treated as partnerships for U.S. federal income tax purposes.

PRS1, PRS2, PRS3, PRS4, and PRS5 each owns land in FC1 that it net leases to unrelated third parties. Y8 provided a loan to an unrelated FC1 corporation.

FC2 Entities

X4 owns all of the interests in Z1, Z2, Z3, and Z4, all domestic corporations. X3 owns all the interests in Z5, Z6 and Z7, all domestic corporations.

Z1 owns all of the interests in a trust settled in the United States that owns Property A in FC2 that it net leases to an unrelated third party. Z5 is structured like Z1. Z7, Z2, and Z3 each owns a partial interest (six percent, four percent and two percent, respectively) of a trust settled in the United States that was created to own and net lease Property B located in FC2 to a party unrelated to either Z7, Z2, or Z3. Z6 owns all the interest of a trust settled in the United States that owns Property C in FC2 that it net leases to an unrelated person. Z4 is structured like Z6.

Law and Analysis

Dual Resident Corporation Issue

The Taxpayer contends that Y8 is not a dual resident corporation and therefore is not subject to the dual consolidated loss limitations. Y8 is a domestic corporation that is not managed or controlled in FC1. Its only activity is a loan to an unrelated FC1 corporation.

A dual resident corporation is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. Treas. Reg. §

1.1503-2(c)(2). A corporation is taxed on a residence basis if it is taxed as a resident under the laws of a foreign country. *Id.*

A corporation is resident in FC1 if it is either incorporated there (*See* cite1) or it is centrally managed and controlled from FC1 (*See* cite2). Management and control is determined by where the board habitually meets and decides matters of fundamental policy. *Id.*

The taxpayer has represented that Y8 was not incorporated in FC1, and that all board meetings and decisions for the company were conducted in the United States. If this is correct, then we understand that the taxpayer is not a resident of FC1 for purposes of FC1 corporate income tax. The Taxpayer has also represented that Y8 is not taxed by FC1 on its worldwide income. In that case, since Y8 is apparently not a resident of FC1, nor is it taxed on its worldwide income in FC1, it is not a dual resident corporation under the test of Treas. Reg. § 1.1503-2(c)(2).

However, if the company is a “separate unit,” then it is treated like a dual resident corporation. Treas. Reg. § 1.1503-2(c)(2). A separate unit is a foreign branch, an interest in a trust or partnership, or a hybrid entity separate unit. *Id.* Only the foreign branch separate unit might apply in this case.

A foreign branch is “an integral business operation carried on by a U.S. person outside the United States.” Treas. Reg. § 1.367(a)-6T(g). This is a facts and circumstances test. *Id*. Factors indicating a branch include the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by officers or other employees of the U.S. person in carrying out its activities outside the United States. The Taxpayer has represented that Y8 has no offices or employees in FC1 and that the only connection with FC1 is that it has provided financing to an unrelated FC1 corporation through preference shares and a loan. FC1 does not treat Y8 as a resident nor tax it on its worldwide income. Thus, there are no factors that make it immediately apparent that there is a branch. However, we have not reviewed all the details of Y8’s activities and therefore we cannot determine if there was enough activity related to the loan to create a branch. You may wish to explore the facts surrounding the activities of Y8 with regard to this financing arrangement to determine whether the activities are enough to meet the definition of a branch. If these activities constitute a branch, then the branch is a separate unit and thus treated like a dual resident corporation.

An activity is also considered a branch if it constitutes a permanent establishment under the tax treaty the United States has with that foreign country. *Id.* We note, though, that it appears Y8 is not a permanent establishment in FC1. Article z of the tax treaty between the United States and FC1 defines a permanent establishment as a “fixed place of business through which the business of an enterprise is wholly or partly carried on.” Since the company apparently has no offices, no employees, and no other connection to FC1 except for the financing it provided, it does not appear to meet the definition of a permanent establishment.

Exception to the Definition of Dual Consolidated Loss

A. Background

The Taxpayer concedes that its other entities are dual resident corporations, or are treated as dual resident corporations, under Treas. Reg. § 1.1503-2(c)(2). The general rule is that a dual consolidated loss of a dual resident corporation may not be used to offset the income of any member of the affiliated group. § 1503(d)(1), Treas. Reg. § 1.1503-2(b)(1). A dual consolidated loss is the net operating loss of a domestic corporation incurred in a year in which the corporation is a dual resident corporation. Treas. Reg. § 1.1503-2(c)(5). Thus, without an exception, the Taxpayer could not claim the losses of these entities on its consolidated federal income tax return.

There are two exceptions to the rule denying use of a consolidated loss. The first allows the use of the dual consolidated loss where there is an agreement in place between the United States and the foreign country that puts into place an elective procedure in which the losses may only offset income in only one country. Treas. Reg. § 1.1503-2(g)(1). To date the United States has not entered into any such agreement with any foreign country. The other exception permits use of the losses if an election is made by the consolidated group agreeing not to use the loss to offset the income of any other person. The Taxpayer did not make this election for any of these entities and has withdrawn its request for an extension to make the election. Thus, neither exception to the general rule applies.

There is, however, also an exception to the definition of a dual consolidated loss. If this exception is met, then there is no dual consolidated loss and the thus the general rule preventing use of a dual consolidated loss will not apply. This is the exception upon which the taxpayer is relying to justify its use of the losses.

In order to qualify for this exception, two tests must be met: a “stand alone” test and a “carry over” test. The stand alone test is met if the income tax laws of the foreign country do not permit the dual resident corporation to use its losses, expenses, or deductions to offset the income of any other person that is recognized in the same taxable year in which the losses, expenses, or deductions are incurred. Treas. Reg. § 1.1503-2(c)(5)(ii)(A)(1). The carry over test is met if the tax laws of the foreign country do not permit the losses, expenses, or deductions of the dual resident corporation to be carried over or back to be used, by any means, to offset the income of any other person in other taxable years. Treas. Reg. § 1.1503-2(c)(5)(ii)(A)(2). Because most countries provide for loss carryovers in at least some circumstances, the carry-over test is rarely met. *See* T.D. 8434, 1992-2 C.B. 240, 241. The taxpayer must satisfy both tests in order to meet the exception to the definition of a dual consolidated loss.

The burden is on the taxpayer to prove that these tests are met. It is a difficult burden to overcome. That difficulty arises because the taxpayer must prove a negative; that is, the taxpayer must show that it *cannot* use the losses, expenses, or deductions *by any means* to offset the income of another person under the tax laws of a foreign country. Thus, the taxpayer must be able to address every conceivable means by which the losses might be used. For example, under the carry over test, if the taxpayer is able to share its losses, deductions, or expenses through a reorganization, liquidation, sale or other disposition, the taxpayer fails the test and the loss is a dual consolidated loss. Furthermore, if the taxpayer is able to share the losses in a partnership arrangement by using allocations of income and expenses that differ between federal income tax law and the foreign tax law, the carry over test is not satisfied. These examples are not exhaustive; they merely illustrate some of the transactions in which losses might be shared.

The taxpayer cannot show that it meets these tests merely by stating conclusions. Rather, we believe that the taxpayer must present a well reasoned analysis that cites the specific foreign tax laws upon which it relies, together with other substantial authority that may exist, and applies those laws to the particular facts of the dual resident corporation. A well reasoned opinion from tax counsel in the foreign country may be useful if it meets this standard. While the credentials of the expert preparing the opinion may make some difference in the weight given to the opinion, an impressive *curriculm vitae* will not suffice to make conclusory statements persuasive enough to meet the taxpayer's burden. It is the substance of the opinion that is really important.

B. FC1 Entities

PRS1, PRS2, PRS3, PRS5, and PRS4 are all FC1 corporations that are treated as partnerships for federal income tax purposes. They are, therefore, hybrid entity separate units. Treas. Reg. § 1.1503-2(c)(4). As a result, they are treated like a dual resident corporation. Treas. Reg. § 1.1503-2(c)(2). The Taxpayer concedes that these entities are treated as dual resident corporations. It contends, however, that these entities do not have dual consolidated losses because they meet the exception to the definition under Treas. Reg. § 1.1503-2(c)(5)(ii).

FC1 tax law[1] allows corporations to share losses through "claim1". cite3. There are two types of claim1: a "claim2" and a "claim3." The company giving up the loss is the "sharing company" and the company receiving the loss is the "receiving company." During the years at issue, both the sharing company and the receiving company were required to be FC1 companies. cite4.

For claim2, two companies are members of the same group, and thus eligible to share losses, if one is the 75 percent subsidiary of the other or both are 75 percent subsidiaries of a third company. cite5.

For claim3, either the sharing company or the receiving company must be a member of Group1, and the other company must be:

(1) a trading company which is owned by Group1 and which is not the 75 percent subsidiary of any company, or

[1] This discussion of FC1 law is cursory and for general information purposes only; it does not represent a definite conclusion by our office of the effect of FC1 tax provisions. There may be other interpretations of the law by court cases or by the FC1 tax agency, for example, which may be pertinent.

(2) a trading company which is a 90 percent subsidiary of a holding company owned by Group1, or
(3) a holding company that is owned by Group1 and that is not a 75 percent subsidiary of any company.

cite6.

The taxpayer represents that, during 1995 and 1996, PRS1, PRS2, PRS3, PRS4, nor PRS5 owned any interests in a subsidiary. It also represents that each of these corporations only had U.S. corporations as shareholders. Assuming these facts are correct, then PRS1, PRS2, PRS3, PRS4, and PRS5 could not qualify for claim1 because they did not meet the requirements for either claim2 or claim3. As a result, these entities appear to meet the stand alone test since they were not eligible for claim1 in Year 1 and Year2.[1] *See* Treas. Reg. § 1.1503-2(c)(5)(ii)(A)(1).

However, the taxpayer must also satisfy the carry-over test in order to meet the exception to the definition of a dual consolidated loss. Here, the taxpayer has, at this point, failed to meet its difficult burden to prove it satisfies this test.

The taxpayer's arguments for the carry over test are contained in an Opinion A from tax counsel in FC1. The opinion notes that if a FC1 corporation has trading losses it is possible for those losses to be transferred to another company. See, for example, cite7, which allows trading losses to be used in certain reorganizations. Thus, if the losses are trading losses, the carry over test is not met. The opinion states that net leasing of real estate is a "Type I" activity. This may be correct; *see* cite8. It then makes the conclusion that a Type I activity is not a trading activity as those are covered by "Type II." Opinion A, page 11. Notably, "Type II" states it applies in six cases. Case I states that it applies "…in respect of any trade carried on in FC1 or elsewhere *but not contained in Type I*." cite9 (emphasis added). That seems to imply that a "Type I" activity may include a trade. Thus, because it lacks analysis, we believe that Opinion A does not support its conclusion that a "Type I" activity cannot include a trade. This problem could be solved if a definition of a trade was provided. But Opinion A does not do that, either. It simply points to cite10, which states that a trade "includes" a vocation, or an office or employment. It then states, without support, that a passive activity like net leasing is "too passive" to constitute a vocation. Even if the opinion was able to support the statement that net leasing cannot constitute a vocation, the definition simply says a trade "includes" a vocation, but does not seem to exclude the possibility that other activities may also constitute a trade. Therefore, you may wish to ask the Taxpayer to provide further support for its claim that none of the losses used from PRS1, PRS2, PRS3, PRS4, and PRS5 included a trading loss. Note that if any part of the loss may be used to offset the income of another person, then the entire loss is a dual consolidated loss.

Even if the losses are not trading losses, the Taxpayer must establish that those losses cannot be used by any other person by any means under FC1 tax law. The

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[2] FC1 changed it tax laws in Year 4. It is now possible for claim1 to apply even if the corporations are 75% owned by a foreign company.

opinion starts with the proposition that carried forward losses that may not be shared by way of claim1 with another company. The Opinion provides some support for that conclusion, though only by general reference to an entire Chapter of Act1. Therefore, you may wish to ask the Taxpayer for a more detailed analysis to support this contention.

There are other ways that losses might be shared other than directly via claim1 provisions. Opinion A attempts to address this problem by analyzing seven different circumstances.[1] In each of them it concludes that the losses cannot be shared with any other person under FC1 law. However, the analysis focuses only on those events as though they occur in 2001. Some of the relevant provisions of Act1 were amended in Year 3. It is important for the application of the exception to the dual consolidated loss definition to know whether it was possible for the losses to be shared under the law as it existed at the time the losses occurred. Therefore, we believe the Taxpayer must also analyze whether the losses could have been shared under the law as it was in Year 1 and Year 2. Furthermore, Opinion A discusses only the direct use of the carried over losses. It does not discuss indirect use of losses, credits, or deductions, such as by basis carry over. Finally, we note there may be other transactions not covered by the seven mentioned in the opinion by which losses might be shared. You may wish to ask the Taxpayer for additional information and analysis to address these shortcomings.

We note that FC1 has a provision that prevents some companies from sharing losses through claim1 if those losses may be used to offset the income of another person in another country. Cite11. This is known as “mirror legislation” because the concept is similar to § 1503(d). If a company is subject to mirror legislation, it cannot use that as the basis for meeting the exception to the definition of a dual consolidated loss. Furthermore, a company subject to mirror legislation cannot make the election for the agreement under Treas. Reg. § 1.1503(g)(2). *See* Treas. Reg. § 1.1503-2(c)(15)(iv). Thus, it would be precluded from using the losses to offset the income of any other member of the consolidated group. Since the Taxpayer in this case has withdrawn its request for extension to make that agreement, we do not need to consider whether the mirror legislation would apply to any of the Taxpayer’s FC1 entities.

C. FC2 Entities

Z1, Z5, Z7, Z2, Z3, Z6 and Z4 are all domestic corporations that have interests in trusts with activity in FC2. These trust interests are separate units. Treas. Reg. § 1.1503-2(c)(3)(i)(C). Because the trust interests are separate units, they are treated like dual resident corporations. Treas. Reg. § 1.1503-2(c)(2). The Taxpayer agrees with this result. However, the taxpayer contends that these interests meet the exception to the definition of a dual consolidated loss described in Treas. Reg. § 1.1503-2(c)(5)(ii). As a result, the Taxpayer states that it is not prohibited from claiming the losses from these interests against its consolidated income.

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[3] The opinion lists eight circumstances, but two of them are actually duplicates.

The argument that the Taxpayer makes to support that claim is that FC2 tax law[4] treats the net leases as a loan arrangement. As a result, the taxpayer states that FC2 tax law does not tax these transactions and the trusts are therefore not recognized at all under FC2 tax provisions.

The Taxpayer has submitted Opinion B in support of it claims. Opinion B starts out with a general explanation of the FC2 tax system. It states that there are two direct taxes imposed in FC2, an income tax and a corporate income tax. The former applies to individuals, while the latter applies to corporations and other entities. General partnerships are not taxed, instead the partners account for their share of partnership items on their returns. Limited partnerships are subject to corporate tax. Resident corporate taxpayers are taxed on their worldwide income, whereas non-residents are taxed only on specified items of FC2 source income. Whether a company is a resident for corporate tax purposes depends on all the facts and circumstances, including the location of effective management, the location of the head office, and the location of the shareholder's general meeting. All of this is well supported by citation to the relevant provisions of FC2 law.

Opinion B also states that a lease in which the property subject to lease is considered, for FC2 tax purposes, as owned by the lessee is treated as though the lessor simply provided financing to the lessee, known as a "financial lease". (Leases in which the lessor is considered the owner for tax purposed are known as "operating leases.") It implies that a financial lease is not subject to income tax in FC2, though it does not provide any citations or analysis to support it.

Assuming the Taxpayer can provide you with support for this position, the question then becomes whether, under FC2 law, the leases at issue are financial leases. Opinion B provides an agreement between the FC2 tax agency and an association of leasing companies that sets forth guidelines for establishing when a lease is an operational lease. It also provides two letters that are apparently signed by FC2 tax officials that describe the leases in which Z7, Z2, Z3, and Z6 participate as financial leases. The Taxpayer claims that Z4 is covered by the same letter as Z6 because its lease is identical to Z6. Thus, if the Taxpayer can show that financial leases are not subject to FC2 income tax, the trusts in which these entities participate would appear not to be taxable in FC2. They would, as a result, meet the stand alone test because these entities have no ability to use losses at all in FC2 in the years in which they were incurred.

Opinion B does not, however, provide any analysis to show that the Z1 and Z5 leases are financial leases. Therefore, we believe more analysis is needed in order to

[4] This discussion of FC2 law is cursory and for general information purposes only; it does not represent a definite conclusion by our office of the effect of FC2 tax provisions. There may be other interpretations of the law by court cases or by the FC2 tax agency, for example, which may be pertinent.

establish that these are financial leases. If the Taxpayer can provide that, these two entities may also meet the stand alone test.

However, Z7, Z2, Z3, Z6, Z4, Z1, and Z5 must also meet the carryover test in order to meet the exception to the definition of dual consolidated losses. Opinion B attempts to meet this test by describing ten transactions and concluding that none of them would permit these entities to share their losses with another person under FC2 law. It states that FC2 law requires a step up (or step down) in basis when effective management of a company is transferred to FC2, and provides case law as support. Unfortunately, apart from that, it provides no analysis or citation to law to back up the conclusions that these transactions would not permit another person to use the losses. Thus, we believe Opinion B appears not to meet the carry over test. Even if the Taxpayer demonstrates that these ten transactions would not result in the ability of another person to use the loss, we note that these transactions may not cover all the possible transactions in which losses might be shared. Thus, the Taxpayer must satisfy you that it meets this test.

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Please contact our office at (202) 622-3860 if you have any questions or need further assistance.

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