**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

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subject: Section 1503(d) Issues Upon Termination of Section 1504(d) Election

This Chief Counsel Advice responds to your request for assistance. In accordance with section 6110(k)(3), this advice may not be used or cited as precedent.

LEGEND

The Company =

Subsidiary =

Date 1 =

Date 2 =

Date 3 =

Country X =

| | |
|---|---|
| Year A | = |
| Year B | = |
| Year C | = |
| Year D | = |
| Year E | = |
| Year F | = |
| Year G | = |
| Year H | = |
| $ a | = |
| $ b | = |
| $ c | = |
| $ d | = |
| $ e | = |
| $ f | = |
| $ g | = |
| Business Y | = |

FACTS

Subsidiary was incorporated in Country X on Date 1. Subsidiary is indirectly owned by the Company, a domestic corporation. The Company made an election under section 1504(d)[1] to treat Subsidiary as a domestic corporation, and included Subsidiary in its consolidated income tax return beginning in Year A. Between Year B and Year G, Subsidiary incurred net losses in the following amounts: Year B: $ a; Year

[1] Unless otherwise noted, “section” references are to the Internal Revenue Code of 1986, as amended, and “Treas. Reg. §” references are to the Treasury Regulations promulgated thereunder.

C: $ b; Year D: $ c; Year E: $ d; Year F: $ e; and Year G: $ f. The total amount of these losses is $ g. These losses were dual consolidated losses ("DCLs") as defined in Treas. Reg. § 1.1503-2(c)(5).

The Company filed elections and agreements under Treas. Reg. § 1.1503-2(g)(2) with its income tax returns in which it elected to use these DCLs to offset its other income ("(g)(2) agreements"). It certified that no portion of the DCLs had been used to offset the income of another person under the income tax laws of a foreign country. It also certified that arrangements were made to ensure that no portion of the DCLs would be used to offset the income of another person under the laws of a foreign country, and that the Company's group would be informed of any such foreign use of any portion of the DCLs. The Company also certified that it would comply with all of the provisions of Treas. Reg. § 1.1503-2(g)(2)(iii)-(vii), such that, if these certifications were violated, the DCLs would be subject to recapture with interest unless a rebuttal could be made.

The Company has taken the position that the section 1504(d) status of Subsidiary terminated in Year H as a result of a change in Country X law. Accordingly, Subsidiary was no longer regarded as a domestic corporation for U.S. tax purposes beginning in Year H, so that it was no longer includible in the Company's affiliated group in Year H or thereafter. As a result of the section 1504(d) termination, the Company initiated an affirmative audit adjustment. As described above, the Company filed (g)(2) agreements for the DCLs that were incurred prior to the section 1504 termination. However, the Company did take into income on its return for the year of the termination any DCL recapture as required under Treas. Reg. § 1.1503(g)(2)(vii).

On Date 2, the Internal Revenue Service (the "Service") informed the Company that the termination of the section 1504(d) election of Subsidiary constituted a presumptive triggering event under the DCL regulations applicable to the years at issue. It also indicated that, if the Company believed that it could make a rebuttal to avoid recapture of those DCLs, it should have filed such a rebuttal with its Year H tax return. The Company did not file a rebuttal with its Year H tax return, and had not filed a rebuttal as of Date 2. Accordingly, the Company sought permission to file a late rebuttal pursuant to the reasonable cause relief provisions of the final DCL regulations issued in 2007. The Service granted this relief. On Date 3, the Company provided the Service with a memorandum in which it claimed that the DCLs were not subject to recapture because they could not be used by another person under the provisions of Country X law following the section 1504(d) termination.

## LAW AND ANALYSIS

I. Termination of the Section 1504(d) Election

By virtue of the section 1504(d) election made on behalf of Subsidiary, the Company treated Subsidiary as a domestic corporation, and hence as a member of its affiliated group, during the years at issue. Section 1504(d) permits certain Canadian and Mexican corporations to be treated as domestic affiliates of their U.S. owners notwithstanding the general prohibition on foreign corporations being members of domestic affiliated groups under section 1504(b)(3). Thus, losses incurred by Subsidiary during the years when the section 1504(d) election was in effect could be used to offset the Company's consolidated taxable income for those years so long as it complied with the provisions of Treas. Reg. § 1.1503-2(g)(2).

Section 1504(d) requires that a corporation with respect to which the election is in effect be maintained solely to comply with foreign law as to title or operation of property. Thus, a change in the applicable foreign law regulating the title or operation of property, which makes it unnecessary for the corporation to be organized under the law of the foreign country, generally will terminate the corporation's section 1504(d) election as of the date of the change in law. For example, Notice 2000-7, 2000-1 C.B. 419, indicates that as a result of a change in Canadian law that allowed U.S. banks to operate in Canada in branch form, the section 1504(d) status of Canadian corporations that had been formed by U.S. banks to allow them to operate in Canada would be terminated.

The Company claims that the section 1504(d) election of Subsidiary terminated in Year H as a result of a change in Country X law. For purposes of this analysis, we will assume that the section 1504(d) status of Subsidiary terminated in Year H.

II. Recapture of the Dual Consolidated Losses

A. The Losses of Subsidiary were DCLs Subject to Recapture.

Subsidiary was a domestic corporation for federal tax purposes during the years at issue as a result of the section 1504(d) election. The losses it incurred arose from its Country X operations, which constituted a foreign branch within the meaning of Treas. Reg. § 1.367(a)-6T(g) and therefore a "separate unit" for purposes of the DCL regulations. Treas. Reg. § 1.1503-2(c)(3)(i)(A). A separate unit is treated as a domestic corporation for purposes of these regulations. Treas. Reg. § 1.1503-2(c)(1). Hence, the DCL rules apply to losses incurred by a separate unit in the same manner as losses incurred by a dual resident corporation ("DRC"). Treas. Reg. § 1.1503-2(c)(2). Therefore, the net operating losses ("NOLs") incurred by the Country X branch of Subsidiary during the years at issue were DCLs. Treas. Reg. § 1.1503-2(c)(5).

Under the regulations applicable to the years at issue, a DCL of a DRC or separate unit generally could not offset the taxable income of a domestic affiliate in the taxable year in which the DCL was recognized, or any other taxable year. Treas. Reg. § 1.1503-2(b)(1). A taxpayer could use a DCL to offset income of a domestic affiliate, however, if the taxpayer elected to be bound by certain requirements. Treas. Reg. § 1.1503-2(g)(2)(i). In particular, an electing taxpayer was required to file an agreement with its timely filed tax return for the year in which the DCL was incurred which certified, inter alia, that no portion of the DRC's or separate unit's losses taken into account in computing the DCL had been or would be used to offset the income of any other person under the income tax laws of a foreign country. Treas. Reg. § 1.1503-2(g)(2)(i)(E). The taxpayer also was required to agree that if a "triggering event" as described in the regulations occurred, and no exception applied, then the taxpayer would recapture and report as income the amount of the DCL on its tax return for the taxable year in which the triggering event occurred, and pay any applicable interest charge. Treas. Reg. § 1.1503-2(g)(2)(iii)(A). Thus, a DRC or separate unit that made these certifications could use the DCL to offset income of a domestic affiliate, but the DCL would have to be recaptured if a subsequent triggering event occurred. The Company made these certifications with respect to the DCLs incurred by the Country X branch of Subsidiary during the years at issue.

Because these losses were DCLs, and had been certified as such by the Company, the losses were subject to recapture if a triggering event occurred. The termination of Subsidiary's section 1504(d) election constituted a triggering event that should have resulted in the recapture of the DCLs.

B. The Termination of Subsidiary's Section 1504(d) Status Triggered Recapture of the DCLs.

The regulations under section 1503(d) describe several events that presumptively trigger the recapture of DCLs. For most of these, the regulations describe the factual situation that presumptively triggers the recapture rule, and then provide an opportunity for a taxpayer to rebut this presumption. Four of the triggering events potentially apply to this case. The first such event occurs where:

> In any taxable year up to and including the 15$^{th}$ taxable year following the year in which the dual consolidated loss that is the subject of the agreement filed under this paragraph (g)(2) was incurred, any portion of the losses, expenses, or deductions taken into account in computing the dual consolidated loss is used by any means to offset the income of any other person under the income tax laws of a foreign country . . .

Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(1) ("Triggering Event (1)").

The second potentially applicable triggering event, which involves the disaffiliation of a DRC, occurs where:

> An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group that filed the election. For purposes of this paragraph (g)(2)(iii)(A)(2), a dual resident corporation or domestic owner shall be considered to cease to be a member of the consolidated group if it is no longer a member of the group within the meaning of § 1.1502-1(b), or if the group ceases to exist because the common parent is no longer in existence or is no longer a common parent or the group no longer files on the basis of a consolidated return . . .

Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2) ("Triggering Event (2)").

The third potentially applicable triggering event, which involves the transfer of assets of a separate unit, occurs where:

> A domestic owner of a separate unit transfers assets of the separate unit in a transaction that results, under the laws of a foreign country, in a carryover of the separate unit's losses, expenses, or deductions. For purposes of this paragraph (g)(2)(iii)(A)(5), a transfer, either in a single transaction or a series of transactions over a twelve-month period, of 50% or more of the separate unit's assets (measured by the fair market value of the assets at the time of the transfer (or for multiple transfers, at the time of the first transfer)), shall be deemed a triggering event . . .

Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(5) ("Triggering Event (5)").

Finally, the fourth potentially applicable triggering event, which involves the transfer of interests in a separate unit, occurs where:

> A domestic owner of a separate unit, either in a single transaction or a series of transactions within a twelve-month period, sells, or otherwise disposes of, 50% or more of the interest in the separate unit (measured by voting power or value) owned by the domestic owner on the last day of the taxable year in which the dual consolidated loss was incurred. For purposes of this paragraph (g)(2)(iii)(A)(7), the domestic owner shall be deemed to have disposed of its entire interest in a hybrid entity separate unit if such hybrid entity becomes classified as a foreign corporation for U.S. tax purposes . . .

Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(7) ("Triggering Event (7)").

Indeed, the section 1504(d) termination with respect to Subsidiary fits the description of all four of these triggering events.[2] First, Triggering Event (1) should apply to this case. Although it does not describe a specific type of transaction, Triggering Event (1) applies to any case in which a DCL is actually subject to use under the income tax law of a foreign country. In determining whether a "use" has occurred, Triggering Event (1) must be read in light of the way in which the regulation defines the "use of loss to offset income of a domestic affiliate or another person." Under that definition,

> "[A] loss, expense, or deduction taken into account in computing a dual consolidated loss shall be deemed to offset income of another person under the income tax laws of a foreign country in the year it is <u>made available for such offset</u>" (emphasis added).
>
> Treas. Reg. § 1.1502-3(c)(15)(ii).

Thus, for purposes of Triggering Event (1), it is not only the *actual* use of a DCL that matters but also the fact that a DCL has been made *available* for use under foreign income tax law. As a result, Triggering Event (1) should apply to any case in which a DCL is either subject to use under foreign law, or available for such use. Thus, although Triggering Event (1) is not written with a particular type of transaction in mind, it embodies the same principle as the other triggering events, which presumptively trigger recapture when it appears that a DCL *could be available* for use, but do not apply if a taxpayer can establish that the DCL was *not available* for use. Therefore, it is not sufficient that the Company never actually used the loss to offset income of a foreign corporation. If the loss was available for use by Subsidiary to offset its own income after it became a foreign corporation or to offset the income of some other person, the loss is subject to recapture under Triggering Event (1). The issue of why the offset of Subsidiary's own income after it becomes a foreign corporation is an offset against the income of another person is discussed in more detail below.

Second, Triggering Event (2) (disaffiliation) applies because Subsidiary ceased to be a member of the Company's consolidated group in Year H and became a foreign corporation for U.S. tax purposes. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2). Although the DCLs at issue arose not within Subsidiary itself but within the Country X branch of Subsidiary, which as described above is a "separate unit," Triggering Event (2) nevertheless applies to this situation. Subsidiary was an "affiliated domestic owner" within the meaning of the regulation because it was an affiliated domestic corporation that owned the separate unit that incurred the DCLs. Treas. Reg. § 1.1503-2(c)(10).

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[2] We note that Triggering Event (4) also could be interpreted as applying to this case. It is similar to Triggering Event (5), but applies to a transfer of the assets of a DRC rather than to a transfer of the assets of a separate unit. However, the regulation defining "dual resident corporation" states that, "unless otherwise indicated, any reference in this section to a dual resident corporation refers also to a separate unit." Treas. Reg. § 1.1503-2(c)(2). The applicability of Triggering Event (4) is not discussed in this memorandum because it does not materially aid in the discussion, except to demonstrate how difficult it would be for the Company to avoid being subject to these triggering events.

Triggering Event (2) explicitly applies to the disaffiliation of an affiliated domestic owner and therefore this disaffiliation comes within the scope of Triggering Event (2).

Third, Triggering Event (5) (transfer of a separate unit's assets) applies as a result of the deemed transfer by Subsidiary of its assets, including the assets comprising the Country X branch, to a foreign corporation as a result of the section 1504(d) termination. This deemed transfer follows from the treatment of a section 1504(d) termination under the section 367(a) regulations, which treats the termination as a transfer of the assets of the former domestic corporation to a new foreign corporation in a constructive reorganization described under section 368(a)(1)(D). Treas. Reg. § 1.367(a)-1T(c)(5). Although the first sentence of Triggering Event (5) defines this triggering event by reference to whether the transfer results in the carryover of the separate unit's losses, expenses, or deductions under foreign law, the second sentence makes clear that the transfer of 50% or more of a separate unit's assets shall be deemed a triggering event unless the taxpayer can make a rebuttal as required by the regulation. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(5). Therefore, Triggering Event (5) by its terms applies to this transfer. Whether this transaction also comes within the first sentence of Triggering Event (5) will be discussed later in this memorandum.

Fourth, Triggering Event (7) (transfer of interests in a separate unit) likewise applies in this situation because the deemed transfer of the assets of Subsidiary by the domestic corporation to the new Country X corporation results in a disposition of all of the domestic corporation's interests in the separate unit. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(7). The language of Triggering Event (7) accurately describes the deemed transfer of the Country X branch by the former "domestic" Subsidiary to a new "foreign" Subsidiary, the Country X corporation that results from the section 1504(d) termination.

C. <u>The Company Has Not Rebutted the Presumed Triggering Events.</u>

The Company has failed to establish that the triggering events described above do not apply to this case. As described above, Triggering Event (1) would require recapture of the DCLs with no possibility of rebuttal if the losses in question were available to be used by another person under the laws of a foreign country. The Company has not provided us with any information to suggest that the DCLs in question were not available for such foreign use.[3]

Even if Triggering Event (1) did not apply, recapture of the DCLs still would be required under Triggering Events (2), (5), and (7) unless the Company could make a rebuttal satisfying the requirements of those triggering events. Each triggering event provides for a separate standard that a taxpayer must meet in order to make a

[3] Our discussion of Triggering Events (2) and (7) below explains why the DCLs in question were available for use by "another person" under Country X law.

successful rebuttal. These standards vary somewhat in their details, but all focus on the general issue of whether the DCLs could carry over to be used by another person.

Such a rebuttal should have been attached to the Company's timely filed return for Year H, the year of the presumed triggering event. Treas. Reg. § 1.1503-2(g)(2)(iii)(B). Because the Company did not submit a timely rebuttal, the Company was required to obtain relief to make a late rebuttal. For relief to make a late rebuttal, the Company was subject to the procedures of the 2007 final regulations under section 1503(d).[4] Under those procedures, the Company was required to demonstrate to the Director of Field Operations, LMSB, that its failure to make a timely rebuttal was due to reasonable cause and was not due to willful neglect. Treas. Reg. § 1.1503(d)-1(c)(1). In this case, the Service concluded that the Company's failure to make a timely rebuttal was due to reasonable cause and therefore that its rebuttal would be evaluated on the merits.

Because we conclude that the termination of Subsidiary's section 1504(d) election was presumptively subject to Triggering Events (2), (5), and (7), then even if Triggering Event (1) did not apply, the Company must make a successful rebuttal under all three triggering events in order to avoid recapture of the DCLs in this case. We believe the Company has failed to make a successful rebuttal under any of these triggering events.

1. <u>The Company has not made a successful rebuttal under Triggering Event (2) or Triggering Event (7).</u>

To make a successful rebuttal under either Triggering Event (2) or Triggering Event (7), the Company must demonstrate, to the satisfaction of the Commissioner, that the DCLs incurred by the Country X branch of Subsidiary could not be used to offset the income of another person under the laws of Country X. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2) and (7). The Company has not made this showing.

a. <u>Subsidiary is "another person" relative to the section 1504(d) corporation following the termination.</u>

The Company has not demonstrated that the DCLs could not be used to offset the income of another person under the laws of Country X. In an effort to make this showing, the Company has provided copies of Country X statutes which ostensibly prevent NOLs incurred by Subsidiary from carrying over to offset the income of an acquiring corporation. These statutes focus on whether the loss may be used by a corporation other than Subsidiary.

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[4] The reasonable cause relief standard of the 2007 final regulations now applies for all untimely DCL filings, including those for DCLs incurred in prior years. Treas. Reg. § 1.1503(d)-8(b)(3)(i).

As a threshold matter, however, the Company has not shown that the DCLs incurred by the Country X branch of Subsidiary, when it was a domestic corporation for U.S. tax purposes, could not be used to offset the income of Subsidiary itself, after it became a foreign corporation following the section 1504(d) termination. Indeed, the Company contends that such a showing is not necessary. It contends that "foreign" Subsidiary is not another person relative to the former "domestic" Subsidiary within the meaning of the DCL regulations. This position is based upon its interpretation of the following language in Triggering Event (2):

> "Such disaffiliation, however, shall not constitute a triggering event if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the dual resident corporation's or separate unit's losses, expenses, or deductions cannot be used to offset income of another person under the laws of a foreign country at any time after the affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group" (emphasis added).[5]

The Company reads Triggering Event (2) as applying only where the DCL in question can be used to offset income of an entity that is "another person under the laws of a foreign country." That is, it reads the phrase "under the laws of a foreign country" as modifying "another person." Under that reading, Triggering Event (2) would not apply to the use of the DCLs by "foreign" Subsidiary, because "foreign" Subsidiary is not another person under Country X law relative to "domestic" Subsidiary. Because the section 1504(d) termination is not regarded under Country X law, Subsidiary is the same person before and after the termination. Under this reading, Triggering Event (2) would only apply if the DCLs could be used by an entity that was viewed as separate from Subsidiary under Country X law.

The problem with the Company's interpretation is that it fails to take into account the context of the recapture provision in as it relates to the rest of the regulation and the policy underlying it. Indeed, the Company's view would permit the kind of double-dipping of losses that Congress sought to deny in enacting section 1503(d). Rather, as described in more detail below,Triggering Event (2) applies in this case because the DCL is available to *offset*, under the income tax laws of a foreign country, the income of *another person*, "foreign" Subsidiary.

i. The section 1504(d) termination results in a transfer to another person within the meaning of the regulation.

[5] Although the Company has not specifically addressed the interpretation of this phrase in Triggering Event (7), the two phrases are identical, and therefore the arguments supporting our interpretation of this phrase in Triggering Event (2) apply with equal force to Triggering Event (7).

First, the DCL regulations are U.S. tax rules that apply to transactions that have U.S. tax consequences, whether they be transactions that actually occur or that are simply deemed to occur from a U.S. tax perspective. For example, one event that presumptively triggers the recapture of DCLs is the disposition of 50% or more of the interests in a separate unit by its domestic owner. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(7). Significantly, this not only includes an *actual* transfer of the interests in a separate unit, but also a *deemed* transfer of interests that occurs when a hybrid entity separate unit becomes classified as a foreign corporation for U.S. tax purposes. In other words, when an entity that is disregarded for U.S. tax purposes, but taxed as a corporation by a foreign jurisdiction, makes a "check the box" election to be treated as a foreign corporation for U.S. tax purposes, this constitutes a transfer of a separate unit to a new foreign corporation for purposes of the DCL rules. Nevertheless, from a foreign law perspective the entity does not become "another person" solely because its owner has made a "check the box" election on its behalf. But because this transaction is deemed to occur for U.S. tax purposes, it is subject to this triggering event to the same extent as an actual transfer.

With this principle in mind, the U.S. tax rules that govern transfers of property to foreign corporations view the termination of Subsidiary's section 1504(d) election as a transfer of assets to a new foreign corporation. The temporary regulations under section 367(a) provide that the termination of a corporation's section 1504(d) election will be treated as a "constructive reorganization and transfer of property from a domestic corporation to a foreign corporation." Treas. Reg. § 1.367(a)-1T(c)(5).[6] In the example that follows this regulatory language, Y is a domestic corporation that previously had made a section 1504(d) election to treat its wholly owned Canadian subsidiary, C, as a domestic corporation. When C no longer qualifies for the election, a constructive "D" reorganization occurs. The example confirms that this results in a "constructive transfer of assets by 'domestic' corporation C to Canadian corporation C" which is fully subject to the outbound transfer rules of section 367(a). That is, the regulation views "domestic" C and "Canadian" C as two separate corporations.

Although Subsidiary has always been organized in Country X and subject to the laws of Country X, both before and after the section 1504(d) election, the section 367(a) regulations treat it as a domestic corporation that transferred its assets to a Country X corporation in Year H and then went out of existence. Because the regulations treat Subsidiary as a new Country X corporation – and thus another person – after the section 1504(d) termination, the DCLs incurred by the Country X branch of "domestic" Subsidiary are able to be used by another person after that date.

Even though this deemed transfer of the assets of Subsidiary to a Country X corporation has no significance from a Country X standpoint, it has significance for U.S. federal tax purposes. As a result of this deemed transfer, the income "foreign" Subsidiary earns from its operations in Country X is no longer subject to tax in the

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[6] *See also* Treas. Reg. § 1.6038B-1T(b)(4)(ii).

United States. That is, the termination has great significance for U.S. tax purposes because it removes Subsidiary from U.S. taxing jurisdiction. The section 367(a) regulations explicitly describe a section 1504(d) termination as a transfer of assets to a foreign corporation for purposes of taxing the gain on the transfer when the assets are removed from U.S. taxing jurisdiction. Given the purpose for this rule, and the purpose of the DCL regulations, it would be incongruous if this transfer were not also deemed to occur for purposes of determining whether there has been a rebuttal.

Indeed, the federal tax regulations contain many examples of "deemed" transactions which nevertheless have the same tax consequences as their actual counterparts. For example, the entity classification regulations under section 7701 provide that when the classification of an entity changes for federal tax purposes – such as when a corporation makes an election to be treated as a partnership – all the tax consequences that normally attend the actual conversion from one type of entity to another will apply. Treas. Reg. § 301.7701-3(g)(2)(i). For this reason, the conversion of a hybrid entity separate unit to a foreign corporation presumptively triggers recapture of the separate unit's DCLs in the same manner as an actual transfer to a foreign corporation. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(7).

Similarly, the Service has issued rulings and regulations addressing cross-border "F" reorganizations in which a single entity changes its place of incorporation from the United States to a foreign country or vice-versa. Although these transactions usually do not involve actual transfers of property to a new entity, they are treated as actual transfers for U.S. tax purposes. Rev. Rul. 87-27, 1987-1 C.B. 134, for example, provides that the reincorporation of a DRC organized in the United States into the United Kingdom constitutes a mere change in the DRC's place of incorporation under section 368(a)(1)(F), but will be treated for U.S. tax purposes as the transfer of the DRC's assets and liabilities to a new U.K. corporation in exchange for its stock followed by the liquidating distribution of that corporation's stock by the DRC to its shareholder. The ruling provides that these transfers generally will be subject to section 367(a), subject to certain limited exceptions. Further, the regulations under section 367(a) which incorporate these rules provide that "it shall be immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transfer corporation." Treas. Reg. § 1.367(a)-1T(f), flush language. That is, the regulation deems a transfer to have occurred even if no actual transfer occurs under foreign law. Finally, Rev. Rul. 88-25, 1988-1 C.B. 116, holds that the conversion of a foreign corporation into a U.S. corporation, which did not require an actual reincorporation in the United States but merely the filing of certificates with a state official, would be treated for U.S. tax purposes as a transfer of the foreign corporation's assets to a new U.S. corporation. The ruling holds that sections 367 and 897 potentially apply to this transfer. Thus, these authorities make it clear that, in the case of cross-border reincorporations that may not involve any change in the entity for local law purposes, the federal tax law will view them as actual asset reorganizations.

In such cases, transactions that result in “deemed” transfers under the Code and regulations have just as much significance for federal tax purposes as actual transfers. Thus, there is no reason to treat a “deemed” transfer of the assets of Subsidiary to a new Country X corporation as having any less substance than an actual transfer for purposes of the DCL recapture rules under section 1503(d).

ii. The policy of section 1503(d) supports treating Subsidiary as another person.

The Company’s argument that the DCL recapture rules should not apply to the losses incurred by the Country X branch of Subsidiary is based on a narrow and improper interpretation of the regulation. Under this interpretation, only the use of a DCL by a separate local law entity – other than Subsidiary – should trigger recapture. This interpretation, however, overlooks the policy behind the DCL rules. This is that the DCL rules should apply to any situation in which a loss can be used to offset two different streams of income (“double dip”). This may occur, for example, where a loss offsets both income earned by a U.S. person that is reported on a U.S. income tax return, and income that is reported on a foreign income tax return and is not subject to immediate U.S. taxation. This type of double dip may occur even if the loss does not offset the income of both a domestic affiliate of the DRC and a separate foreign corporation.

The case at hand represents exactly the type of “double dip” that the DCL rules were designed to prevent. If the regulations did not treat the new “foreign” Subsidiary as another person relative to the former “domestic” Subsidiary, then the DCLs in question could be used to offset both the U.S. income of the Company, and the Country X income of Subsidiary. Thus, neither stream of income would be subject to current tax, and while the foreign income of Subsidiary would ultimately be subject to U.S. tax on repatriation, such tax would be deferred indefinitely until then. Although Subsidiary is not a separate local law entity relative to the entity that incurred the DCL, this case is nevertheless a “double dip.” In order for the regulations to appropriately deal with this case, it is necessary to view “foreign” Subsidiary as another person relative to “domestic” Subsidiary.

The Company contends that the DCL regulations in effect during the years at issue were not intended to broadly cover all cases in which this type of “double dip” occurred, but were narrowly drafted to deal only with situations in which a loss arising in a DRC was used to offset the income of both an affiliated U.S. corporation and a separate foreign corporation. However, it is clear from both the history of section 1503(d) and the regulations that the broader “double dipping” transaction was always considered to be within the scope of the DCL rules.

First, the legislative history describes the reach of section 1503(d) in broad terms. Although it principally describes the "inbound" paradigm transaction,[7] it also speaks to a broader range of transactions. It states that "[l]osses (however derived) that a corporation uses to offset foreign tax on income that the United States does not subject to current tax should not also be used to reduce any other corporation's U.S. tax." Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 1064 – 1065 (1987). This statement shows that Congress was troubled by the use of a loss to offset current tax on a stream of foreign income, and not simply the use of a loss to offset the income of a separate foreign corporation. Thus, the use of the DCLs of Subsidiary to reduce current tax on its Country X income represents the type of abuse that Congress was concerned about.

This concern is also evident in the language of section 1503(d) itself. Section 1503(d)(2)(B) states that "to the extent provided in regulations, the term 'dual consolidated loss' shall not include any loss which, under the foreign income tax law, does not offset the income of any foreign corporation." Stated conversely, it is reasonable to assume that Congress viewed as suspect any loss which, under foreign income tax law, <u>does</u> offset the income of any foreign corporation. In the transaction at issue, it is clear that the DCLs of the Country X branch of Subsidiary will offset the income of a foreign corporation – <u>i.e.</u>, "foreign" Subsidiary following the section 1504(d) termination.

In the regulations, this broad policy is made explicit in the preamble to the final DCL regulations issued in 1992. The preamble states that:

> Section 1503(d) was enacted to prevent a single economic loss from being used to reduce tax on two separate items of income – one of which is subject to current tax in a foreign country but not in the United States, and the other of which is taxed in the United States but not the foreign jurisdiction. Through such "double dipping," worldwide economic income can be rendered partially or fully exempt from current taxation. Moreover, even if the foreign income against which the loss is used will eventually be subject to U.S. tax (<u>i.e.</u>, upon a repatriation of earnings), there are timing benefits of double dipping that the statute was intended to prevent.

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

Finally, the examples in the regulations illustrate this policy. In Treas. Reg. § 1.1502-2(c)(16), Example 1, the regulation describes a case in which a U.S. corporation owns a foreign branch which incurs a loss, as well as a foreign corporation organized in the same jurisdiction as the branch. The regulation provides that the branch is a DRC and that the loss it incurs is a DCL. Because the DCL could offset the

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[7] The "inbound" transaction on which the legislative history to section 1503(d) was largely focused involved foreign corporations acquiring U.S. targets through the use of DRC holding companies and using the DRC's losses to offset the income of both the foreign corporation and the U.S. target.

income of the foreign affiliate under the applicable foreign law, the regulation provides that the DCL may offset the branch's own income but may not also be used to offset the income of the U.S. corporation or any domestic affiliate. The implication is that, when the DCL merely offsets the foreign income of the branch itself, the use of the loss does not create the possibility of a "double dip" because the DCL is offsetting foreign income that is subject to current tax because it flows up to a U.S. tax return. However, when the DCL offsets the income of the foreign affiliate, it is reducing current foreign tax on that income, and deferring U.S. tax on that income indefinitely until the income is repatriated. This confirms that the goal of the regulation is not simply to target cases in which a DCL is used by a separate foreign corporation, but more broadly, to target cases in which a DCL offsets two separate streams of income; one of which is subject to tax in the United States and one that is not.

iii. The language of section 1503(d) supports our interpretation of the regulations.

The language of the statute itself supports our interpretation of this phrase in the regulations. In defining a "dual consolidated loss," the statute indicates that regulations will limit this definition to cases in which the loss is not used to offset income of a foreign corporation. In particular, it states that

> the term "dual consolidated loss" shall not include any loss which, under the foreign income tax law, does not offset the income of any foreign corporation.

Section 1503(d)(2)(B).

This provision clearly shows that Congress was concerned with the situation in which a single stream of income be used to offset income of the domestic corporation for U.S. tax purposes and then again used under the provisions of foreign tax law to offset the income of a foreign corporation. As mentioned above, this is the general policy that the regulations were designed to carry out. Implementing this provision, the regulations permit a DCL to be used in the United States if the taxpayer is able to certify that no portion of the loss can or will be used to offset the income of another person under the income tax laws of a foreign country. Treas. Reg. § 1.1503-2(g)(2)(i). Similarly, the regulations do not require recapture of a DCL upon the occurrence of a presumptive triggering event, if the taxpayer is able to show that the loss could not be used to offset income of another person under the laws of a foreign country. See, e.g., Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2).

The statutory language that these regulations implement clearly focuses on the broad question of whether foreign income tax law permits a loss to offset income of a foreign corporation. That is, the words "foreign income tax law" in the statute clearly modify "offset," and not "another person." Given this clear grant of regulatory authority, it seems appropriate that the regulations should be read in the same manner. Thus, the language of the statute itself supports our position that Triggering Events (2) and (7) should apply where the foreign income tax law permits a DCL to offset income of a foreign corporation, even if that corporation is not "another person" relative to the entity that incurred the loss under foreign law.

iv. <u>This interpretation does not render the regulation meaningless.</u>

The Company asserts that our interpretation, which treats Subsidiary as "another person" following the termination, would render the regulation meaningless because it would be impossible for a taxpayer to make a successful rebuttal if the regulation were interpreted in this manner. That is, the Company seems to say that because no change in the status of Subsidiary occurred from a Country X perspective following the termination, there could be no Country X law that would explicitly restrict the use of the DCLs after that date. This is not true. If the Company could show, for example, that the DCLs in question could not carry over to the new "foreign" Subsidiary following the termination because they had expired under Country X law, this may satisfy the rebuttal standard. That is, even if "foreign" Subsidiary were "another person" following the termination, the Company could rebut the presumed triggering event because it could show that "foreign" Subsidiary would be unable to use any expired losses that arose while the section 1504(d) election was in effect. The example in Treas. Reg. § 1.1503-2(g)(2)(iii)(C) illustrates this principle. In that example, a taxpayer is able to rebut a presumed triggering event by showing that the DCL in question expired and thus could not be used by another person.

Further, even if no rebuttal of Triggering Event (2) or (7) were possible *in this circumstance*, this by itself does not render the provision meaningless, because rebuttals would be possible *in other circumstances*. Triggering event (7), for example, clearly can be rebutted in most situations to which it applies, such as where a taxpayer makes an actual transfer of a foreign branch to another local law corporation. The validity of the regulation does not depend on a taxpayer being able to make a successful rebuttal in all circumstances in which a particular triggering event may apply.

<u>b. Even if Subsidiary were not another person, the Company still has not made a successful rebuttal.</u>

Even if the Company were correct that "foreign" Subsidiary was not another person following the section 1504(d) termination relative to "domestic" Subsidiary, it still has not fully met its burden of showing that the DCLs in question would not be available for foreign use. This is because the Company has not addressed one situation in which DCLs could potentially be used by another person – other than Subsidiary – under the laws of Country X. This situation arises because the term "dual consolidated loss" does not merely include NOLs which may carry over to another person under foreign law. Depreciation deductions arising from a DRC's depreciable property enter into the computation of a DCL as well. Thus, in a case in which depreciable assets of a DRC are acquired by another person, and the basis of such assets carries over to the acquirer, a DCL may be embedded in the basis of such assets. If depreciation deductions with respect to such assets are deferred under foreign law relative to U.S. law, then the realization of these deductions by the foreign acquirer constitutes the foreign use of a DCL. This may occur in any situation in which an asset has a longer depreciable life under the tax law of the foreign jurisdiction than under U.S. tax law, such that depreciation deductions arise for foreign tax purposes in years after they have arisen for U.S. tax purposes.[8]

This principle is illustrated in the following example. During year 1, X is a dual resident of the United States and country Q and is a member of a U.S. consolidated group. X has no income but incurs $100 of depreciation for U.S. tax purposes. This $100 loss is a DCL that it uses to offset its U.S. taxable income in year 1 by filing a (g)(2) agreement. In year 2, X becomes deconsolidated from the U.S. group and merges into Y, a country Q corporation. The basis of X's assets carries over to Y in the merger under country Q law. Because of the difference between U.S. and country Q tax laws, the $100 of depreciation was not realized for country Q tax purposes in year 1, and therefore X retains the depreciable basis in its assets which will give rise to depreciation for country Q tax purposes in the future. In year 2, when X is no longer a member of the U.S. group and has merged into Y, it realizes $100 of depreciation on the assets it received from X for country Q tax purposes. The $100 of depreciation is a use of X's DCL from year 1 by Y, a foreign corporation, and therefore X must recapture the loss. If this were not the case then a clear double-dip of the loss occurs because the loss offsets two separate streams of income, i.e., the income of X while it was a domestic corporation and also the income of Y, a foreign corporation.

Applying this principle to the present case, the Company must show that any DCL incurred by the Country X branch of Subsidiary attributable to the depreciable basis of its assets could not be used by another person under Country X law if such person acquired these assets in a carryover basis transaction. However, the Company has only provided information addressing Country X law governing the carryover of NOLs to an acquiring corporation. Depreciation deductions are not NOL carryforwards and thus are not addressed by these laws. Nevertheless, it is clear that they enter into the computation of the DCLs. Because the Company has not addressed this issue, it has not made a successful rebuttal even if it were to prevail in its argument that Subsidiary is not "another person" as described above.

2. The Company has not made a successful rebuttal under Triggering Event (5).

8 Similarly, the carryover of liabilities or any other item that results in deductions being taken differently for foreign tax purposes than for U.S. tax purposes could result in the foreign use of a DCL.

To make a successful rebuttal under Triggering Event (5), the Company must demonstrate, to the satisfaction of the Commissioner, that the transfer of the assets of the Country X branch of Subsidiary did not result in a carryover under foreign law of the separate unit's losses, expenses, or deductions to the transferee of the assets. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(5). The Company has not made this showing.

As discussed above, the termination of Subsidiary's section 1504(d) election results, under the section 367 regulations, in the deemed transfer of the assets of Subsidiary to a new "foreign" Subsidiary. This transfer is a construct of the regulations, but is recognized for U.S. tax purposes to the same extent as an actual transfer of assets. Nevertheless, it does not result in any change in the status of Subsidiary under Country X law. As a result, it seems unlikely that Country X law would impose any restriction on the use of the DCLs to offset the income of Subsidiary following the termination, given that this transaction is disregarded from a Country X perspective. If there is no restriction on this use of the DCLs under Country X law following the termination, this effectively constitutes a carryover of those losses from "domestic" Subsidiary to "foreign" Subsidiary. It should not matter that the transaction is not regarded under Country X law, because it clearly results in a carryover of the DCLs under Country X law.

Therefore, we believe the deemed transfer of the assets of the Country X branch to "foreign" Subsidiary results in "a carryover under foreign law of the separate unit's losses, expenses, or deductions to the transferee of the assets." Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(5). If this is the case, the Company would be unable to make a rebuttal under Triggering Event (5).

Our conclusion that the Company has not made a successful rebuttal of Triggering Event (5) is consistent with our conclusions as to Triggering Events (2) and (7). Although the regulation applies a slightly different standard in Triggering Event (5) – the carryover of the DCL to a transferee under foreign law as opposed to the use of a loss by "another person" – the underlying concern is the same. In all three cases, the regulation focuses on whether a transaction has occurred in which a DCL is likely to be put to an inappropriate use. That is, if the assets of the Country X branch were able to carry over with their historic basis so that the DCLs would likewise carry over, then the DCLs should also be usable by "another person" within the meaning of Triggering Events (2) and (7). Because this carryover of the DCLs occurs in the present situation regardless of which triggering event applies, we believe the Company has failed to rebut all three triggering events.

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We believe that the position articulated in this memorandum is sound and fully defensible. It is supported by the relevant statutory and regulatory provisions, and is consistent with the intent of Congress and the Service in enacting those provisions. In particular, we believe that the termination of Subsidiary's section 1504(d) election triggered recapture of the Company's DCLs for the years at issue. Nevertheless, this office has not previously given definitive advice or guidance on these issues, and they are not addressed by any published guidance or court opinion.

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Please call (202) 622-3860 if you have any further questions.

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