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to:

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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. This advice may not be used or cited as precedent.

LEGEND

The Company =

Subsidiary =

Country X =

LAW AND ANALYSIS

This memorandum responds to the arguments relating to dual consolidated loss (“DCL”) recapture raised by the Company in its protest submitted on December 18,

2007. Before discussing the Company's specific arguments, however, this memorandum provides a background of the policy underlying the rules applicable to this case.

I. Policy Underlying Section 1503(d)

Section 1503(d) was enacted to prevent a corporation from using a single economic loss to reduce its own U.S. tax and also to reduce foreign tax on a stream of income that is not subject to current U.S. tax.[1] Congress sought to prevent this practice of "double dipping," because it provided an undue tax advantage to certain foreign persons making U.S. investments.

The legislative history to section 1503(d) sets forth a simple example that describes the type of double dip that this provision was enacted to prevent.[2] In that example, shown below in Figure 1 ("Example 1"), a U.K. corporation which earned $100 acquired a U.S. target. The U.S. target also earned $100 of income. To finance the acquisition, the U.K. corporation established a dual resident corporation ("DRC") that incurred interest expense of $100 and earned no income, thus resulting in a loss of $100 for the DRC. Under U.K. law, the DRC's loss was used to offset the income of the parent, which was not taxed in the U.S., such that the group's U.K. taxable income was reduced to $0. Likewise under U.S. law, the DRC was consolidated with the U.S. target, so that its U.S. taxable income was also reduced zero by using the same loss. This results in the double dip — a single loss of $100 offsets two separate streams of income, one subject to tax in the U.S. but not the U.K., and the other subject to tax in the U.K. but not in the U.S. Despite having worldwide profits of $100, the group would pay no tax in either country prior to the enactment of section 1503(d).

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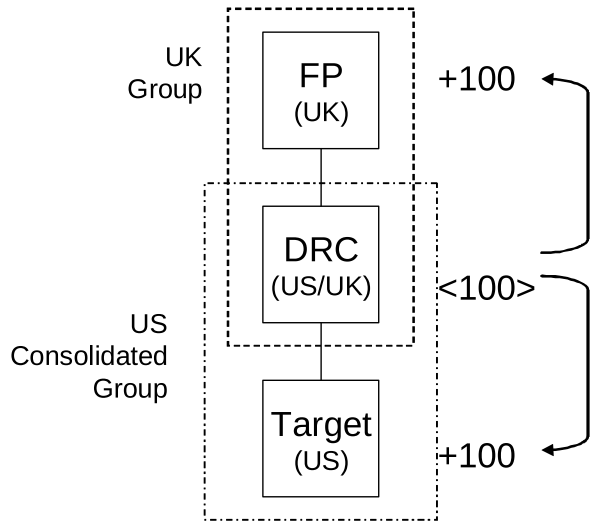
[1] Staff of Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, 1064 (1987). Although this example describes an inbound transaction, the statute applies to both inbound and outbound transactions.

[2] Id.

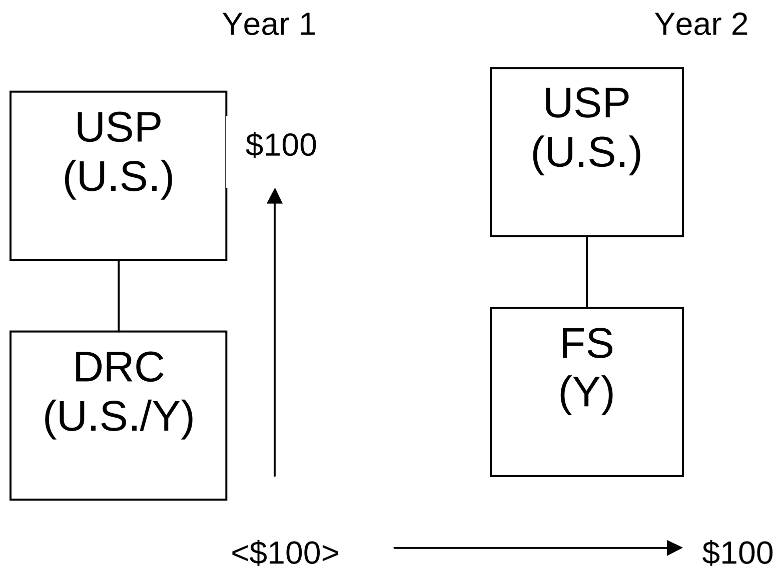
Figure 1



Section 1503(d) and the regulations promulgated thereunder, therefore, sought to prevent situations in which a DCL could be used to offset two separate streams of income in this manner. Although it is clear that the regulations police this type of double dip, this prohibition is also evident under the language of the statute. 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.” In other words, Congress was concerned about the use of a loss to offset, under foreign income tax law, the income of any foreign corporation.

A second example, shown in Figure 2 below, illustrates another situation in which a double dip may occur (“Example 2”). USP is a domestic corporation and the common parent of a consolidated group that includes DRC, also a domestic corporation. DRC is also considered a resident of Country Y because it is managed and controlled there. Thus, DRC is a dual resident corporation. In Year 1, USP has income of $100 and DRC incurs a loss of $100. USP uses the DRC loss to offset its $100 of income so that the group’s income is reduced to zero for U.S. tax purposes and thus no income tax is paid in the U.S. In Year 2, DRC reorganizes to become FS, an entity that is treated as a foreign corporation for U.S. tax purposes but that is considered unchanged from DRC under Country Y law. FS earns $100 of income in Year 2, and uses the $100 of loss incurred by DRC in Year 1 to offset the Year 2 income.

Figure 2



This also creates a double dip — a single loss of $100 offsets two separate streams of income, first offsetting USP's $100 of income subject to U.S. tax in Year 1 and then also offsetting the $100 of FS income in Year 2 that is subject to tax in Country Y but is not subject to tax in the U.S. As in Example 1, there is $100 of overall net income, but because of the double dip, no tax is paid on that $100 in either country. This is exactly the advantage Congress sought to deny in enacting section 1503(d).

Note that this double dip occurs because the loss could be used to offset both the income of a domestic corporation and a foreign corporation, even though under the foreign country law the entity remains unchanged. Thus, what matters in this example is that the foreign law allows the *use* of the loss against the income of an entity that, for U.S. tax purposes, is treated as a foreign corporation. This tracks squarely with the statute, which provides that a 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). The statute thus focuses on the *use of the loss* to offset income of a foreign corporation. That is exactly what occurs in Example 2 above. This illustrates that the triggering event rebuttals in the regulations must be interpreted to provide that "the laws of the foreign country" modifies *use* rather than *another person.* This interpretation is the one that is consistent with the policy and text of the statute.

If DRC had remained a domestic corporation in Year 2, then the $100 of Year 2 income would have been subject to tax in the U.S. In that case, no double dip would have occurred, even though the loss would have been used to offset its income under the foreign country law. In that situation, the $100 of total economic profit would not have escaped tax as it did the example with the double dip. Rather, the U.S. would tax the $100 of income that DRC would have made in Year 2 if it had remained domestic, and the taxpayer would not have enjoyed the advantage of the double dip. This shows the significance of the conversion of DRC to a foreign corporation for U.S. tax purposes even though under the foreign law the entity remains unchanged. That U.S. tax event creates the possibility for a double dip in the absence of section 1503(d).

With these examples and this policy in mind, we turn to a consideration of the treatment of the transaction at issue under the 1992 regulations under section 1503(d) (the "1992 DCL regulations").

II. Treatment of the Transaction Under the Regulations

The central issue in this case is whether the termination of Subsidiary's section 1504(d) status triggered recapture of Subsidiary's DCLs. This depends on whether the termination caused Subsidiary to become "another person" within the meaning of the applicable triggering events under the regulations. That is, all of the applicable triggering events either explicitly or implicitly provide that the transaction would not trigger recapture of the DCLs unless they could be used "to offset income of another person under the laws of a foreign country" at any time after the termination.

In Example 2 above, under the 1992 DCL regulations, the $100 loss incurred by DRC could only be used to offset USP's income if USP filed an election and agreement described in Treas. Reg. § 1.1503-2(g)(2). In that election and agreement, DRC would have to certify that no part of the DCL would be "used to offset the income of any other person under the income tax laws of a foreign country" and that it would comply with the recapture provisions of Treas. Reg. §§ 1.1503-2(g)(2)(iii)-(vii). When DRC converted from a domestic corporation to a foreign corporation, it disaffiliated from the consolidated group. As a result, this would be a triggering event described in Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2) ("Triggering Event 2"). This would require the taxpayer to recapture the $100 DCL that it used to offset USP's income, unless it could show that the DCL "cannot be used to offset income of another person under the laws of a foreign country" at any time after disaffiliation.

In the case at hand, the Company argues that the termination does not trigger recapture because, although the DCLs admittedly could offset the income of the new "foreign" Subsidiary after the termination, Subsidiary is unchanged under Country X law and thus is not "another person under the laws of a foreign country."[3] Our view is that

[3] Example 2 is very close the facts in this case, except that Subsidiary, the dual resident corporation in this case, had a foreign branch separate unit underneath it that actually incurred the loss. Nevertheless, the conversion results in the potential for a double dip in the same way Example 2 does. Furthermore, while Triggering Event 2 does not apply to the Company, the triggering events that do apply have the same wording for the rebuttal standard, so the discussion of the application of Triggering Event 2 to Example 2 also applies to the Company's case.

recapture is required in this case because after the termination, the DCL can "offset" the income of Subsidiary "under the laws of a foreign country" (i.e., Country X) after the termination. As demonstrated above, the result is a potential double dip, which is contrary to the policy underlying section 1503(d). Thus, unless the policies underlying the DCL rules are considered, this case merely involves a linguistic dispute about whether the term "under the laws of a foreign county" modifies "another person" or whether it modifies "offset." The policy cannot, however, be ignored. Where there are two possible interpretations of a rule, the one that is consistent with the policies underlying the rule is the better interpretation. [4]

The Company has pointed to the triggering event in Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(6) ("Triggering Event 6"), which has the same rebuttal standard, stating that our interpretation would render the rebuttal meaningless because it could never be satisfied. The Company's argument is essentially that an unaffiliated dual resident corporation that converts to a foreign corporation for U.S. tax purposes but remains unchanged under the foreign law will always be able to offset the DCL against the income the foreign corporation generates after conversion, making it impossible to meet the rebuttal applying our interpretation of the regulation. However, a rebuttal could still be made if the Company could show that the DCL had expired and could not otherwise carry over to the foreign corporation, such as through the depreciable basis of the corporation's assets. In other words, if the foreign law does not allow the DCL to be *used* to offset income of the entity after it becomes a foreign corporation the rebuttal standard is satisfied. Thus, our interpretation does not render the rebuttal provision meaningless.

The case at hand represents exactly the type of double dip that the DCL rules were designed to prevent, because if no triggering event applied, the DCLs in question could be used to offset two separate streams of income, one taxable in the U.S. and the other taxable in Country X but not taxable in the U.S. In order to avoid this result, the applicable triggering events must be read as treating "foreign" Subsidiary as another person relative to the former "domestic" Subsidiary. As described above, this interpretation is fully consistent with the language and purpose of both the statute and the regulations.

III. The Potential Characterization of the Transaction as an F Reorganization is Not Relevant

[4] It is a fundamental principle of statutory construction that ambiguous terms in a statute should be interpreted in a manner that gives effect to the legislative intent. Gruver v. Commissioner, 142 F.2d 363, 365-66 (4th Cir. 1944) (noting that "[taxpayer's] interpretation has the merit of verbal consistency but we do not think it should be sustained in view of the purpose which Congress obviously desired to achieve"); Anderson v. Commissioner, 123 T.C. 219 (2004) (applying this principle to the interpretation of tax regulations).

The Company also argues that the transaction at issue does not give rise to "another person" because it should qualify as an outbound reorganization under section 368(a)(1)(F) (an "F reorganization"). As a threshold matter, however, the regulations under section 367(a) describe the termination of a section 1504(d) election as a constructive outbound asset reorganization under section 368(a)(1)(D).[5] Although the Company cites Rev. Rul. 87-27 for the proposition that this transaction should be viewed as an F reorganization, nothing in that ruling compels F reorganization treatment for a section 1504(d) termination.[6]

Even if the transaction were properly viewed as an F reorganization, however, it is not clear why F reorganization treatment would be more preferable to the Company than D reorganization treatment. The Company seeks to establish that the transaction is an F reorganization so that it can claim that it does not involve a transfer to "another person" for purposes of the applicable triggering events. That is, the Company seeks to use F reorganization treatment to bootstrap into an argument that the transaction should be exempt from the application of section 1503(d). The Company's position is not supported by the history of the F reorganization rule or the underlying policy issues at stake in this case.

The Company contends that "it is clear as a matter of U.S. law that [an F reorganization] involves only a single corporation that remains unchanged following the reorganization."[7] In support of this statement, the Company cites various authorities in the F reorganization context, as well as the language of section 368(a)(1)(F) itself, which was amended in 1982 to clarify that an F reorganization involves "one corporation." The Company reads too much into the F reorganization rule. First, the legislative history of section 368(a)(1)(F) and the case law in this area principally are concerned with the definitional issue of whether a transaction can be viewed as an F reorganization for purposes of the reorganization provisions (even where the reorganization involves multiple corporations).[8] They do not stand for the proposition that once an F reorganization exists, it must then be respected as involving only one corporation for all tax purposes.

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5 Treas. Reg. §1.367(a)-1T(c).

6 1987-1 C.B. 134.

7 Company Rebuttal at p. 17.

8 For example, when amending section 368(a)(1)(F) to include the phrase "of one corporation," Congress conceded that an F reorganization could involve more than one corporation in certain cases:

> "This limitation does not preclude the use of more than one entity to consummate the transaction provided only one operating company is involved. The reincorporation of an operating company in a different State, for example, is an F reorganization that requires that more than one corporation be involved."

H.R. Rep. No. 760, 540-41 (1982).

This point is amply illustrated by the regulations under section 367, which treat an outbound F reorganization as an asset reorganization into a foreign corporation for purposes of that provision.[9] Thus, for purposes of section 367, an outbound F reorganization involves an asset transfer to a new foreign corporation. Therefore, in terms of the tax treatment of the transaction under the section 367 regulations, the Company fares no better if the transaction is an F reorganization than if it is a D reorganization. The reason for this rule is that a conversion to a foreign corporation creates a substantial change in the tax treatment of the entity, unlike a domestic to domestic F reorganization. For that reason, the international provisions of the Code treat these cross border transactions as having more significance than they do in a purely domestic context. The Company's argument that an F reorganization is always treated as a reorganization involving a single corporation does not explain why it is treated differently for Section 367 purposes or why that same treatment is not similarly appropriate under the DCL rules for a Section 1504 termination. Both sets of rules recognize that the transformation from a domestic corporation to a foreign corporation is a significant change to the entity and cannot simply be ignored.

Although it may be sensible to view the reincorporation of a domestic corporation in a different state as involving a single corporation, this approach is not appropriate in the international context. An outbound F reorganization removes the corporation's assets from U.S. taxing jurisdiction and therefore must be viewed as an outbound asset transfer in order to effectuate the purposes of section 367.[10] For the same reason, the termination of a section 1504(d) election is also viewed as a constructive outbound asset transfer for purposes of section 367. Just as the section 367 regulations effectuate the purpose of section 367 by treating a section 1504(d) termination in this manner, the DCL regulations must also treat the transaction as an outbound reorganization to prevent the double dip that would occur if the DCLs of the former domestic corporation were able to be used to offset the income of the foreign corporation following the termination.

IV. <u>Our Position Does Not Involve a Retroactive Application of the 2007 Regulations</u>

The Company also argues that the government's interpretation, while arguably supported by the 2007 DCL regulations, is not supportable under the 1992 DCL regulations applicable to the year at issue, and that the government's interpretation in effect requires the retroactive application of the 2007 regulations. Although the 2007 DCL regulations certainly clarified the circumstances that require recapture of DCLs, the 1992 DCL regulations were broad enough to cover most double dip situations, including the transaction at issue here. The question at issue in the 1992 DCL regulations is what the phrase "under the laws of a foreign country" modifies. We have interpreted the 1992 DCL regulations in a manner that is consistent with their policy of preventing

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9 Treas. Reg. § 1.367(a)-1T(f).

10 Id. See also Rev. Rul. 87-27; cf. Treas. Reg. § 1.367(b)-2(f).

double dip transactions. Although made explicit in the 2007 DCL regulations, this policy is not new to those regulations, but is implicit in the language of section 1503(d) itself, dating back to 1986. As described above, the language of the statute suggests that a principal concern of Congress in defining whether a loss was a DCL was whether the loss, under the foreign income tax law, could offset the income of any foreign corporation. Section 1503(d)(2)(B). Our position in the present case simply involves an interpretation of the regulations that gives effect to that underlying policy concern.

V. Standard of Rebuttal

Even if Subsidiary were not considered to be "another person" following the section 1504(d) termination, i.e., even if the termination did not constitute an irrebuttable triggering event, the Company has not made an adequate rebuttal. In particular, the Company has not addressed whether a DCL could be used by another person in the form of a carryover basis in the corporation's depreciable assets.[11] For example, a DCL could carry over to a foreign corporation where the corporation acquired assets from a DRC with a carryover basis and, due to timing differences between U.S. law and the applicable foreign law, was able to offset its income with depreciation deductions from the property.

The Company argues that, although depreciation deductions embedded in the carryover basis of assets may come within the broad definition of a "dual consolidated loss" in Treas. Reg. § 1.1502-2(c)(5), this is not something that a taxpayer must address for purposes of rebutting a triggering event. Rather, the Company argues that a rebuttal need only address the potential carryover of "losses, expenses or deductions." However, it is precisely the potential carryover of DCLs that the triggering events are concerned with, and the triggering events do not apply a lesser threshold of what constitutes a DCL. Depreciation deductions that may carry over to another person in the basis of assets are part of the "losses, expenses, or deductions" that constitute a DCL. Thus, if a DCL is embedded in carryover asset basis, then this should be addressed in the Company's rebuttal.

The Company indicates in passing that the depreciable lives of Subsidiary's assets are shorter for Country X tax purposes than for U.S. tax purposes. This statement, if substantiated, could help to establish that a DCL cannot carry over to another person in the form of carryover asset basis. However, the Company has not provided any substantiation for this claim as it did for its claims that a net operating loss could not carry over to another corporation under Country X law.

[11] Because we believe the Company must provide this information to make a satisfactory rebuttal, we do not express an opinion as to whether the information already provided by the Company regarding the ability of another person to use the corporation's losses under Country X law is otherwise adequate to satisfy the rebuttal standard.

For these reasons, we believe that the Company has not rebutted the applicable triggering events, and that the DCLs at issue should be recaptured.

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

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