IN THE SUPREME COURT OF OHIO

NEW YORK FROZEN FOODS, INC. AND AFFILIATES, Appellants/Cross-Appellees, v. BEDFORD HEIGHTS INCOME TAX BOARD OF REVIEW, *et al.*, Appellees/Cross-Appellants.	:	CASE NO. 15-0575 On Appeal from the Ohio Board of Tax Appeals Board of Tax Appeals Case No. 2012-55

FOURTH BRIEF
APPELLEES'/CROSS-APPELLANTS' SECOND MERIT BRIEF

STEPHEN K. HALL (0069009)
RICHARD C. FARRIN (0022850)
Zaino, Hall & Farrin LLC
41 S. High Street, Suite 3600
Columbus, Ohio 43215
(614) 326-1120
(614) 754-6368 (fax)
SHall@zhftaxlaw.com
RFarrin@zhftaxlaw.com

Counsel for Appellants/Cross-Appellees, New York Frozen Foods, Inc. and Affiliates

ANTHONY F. STRINGER (0071691)
Counsel of Record
MATTHEW A. CHIRICOSTA (0089044)
THOMAS R. O'DONNELL (0067105)
CALFEE, HALTER & GRISWOLD LLP
The Calfee Building, 1405 East Sixth Street
Cleveland, Ohio 44114
(216) 622-8200 (phone)
(216) 241-0816 (fax)
AStringer@Calfee.com
MChiricosta@Calfee.com
TODonnell@Calfee.com

Counsel for Appellees/Cross-Appellants, Bedford Heights Income Tax Board of Review and City of Bedford Heights Income Tax Administrator

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INTRODUCTION[1]

Appellees/Cross-Appellants' ("Bedford Heights") Proposition of Law on cross-appeal should be accepted because Appellants' New York Frozen Foods, Inc. ("New York") and Affiliates (collectively, "NYFF") attempt to obtain a net profits tax refund of nearly $700,000 (plus interest) is barred by Bedford Heights Ordinance § 173.15(a). Section 173.15(a) explicitly provides that taxpayers cannot change (among other things) their "method of apportionment of net profits" after the due date for filing their original tax returns. This is precisely what NYFF tried to do here. As explained in detail below, NYFF's attempt to change its "method of apportionment of net profits" by changing from single to consolidated filer status is barred by Section 173.15(a). Accordingly, Bedford Heights respectfully requests that this Court accept Bedford Heights' Proposition of Law on cross-appeal.

ARGUMENT

BEDFORD HEIGHTS PROPOSITION OF LAW NO. 1: BHO § 173.15(a) and the prior version of RITA Rule § 5.06(A) bar NYFF from changing from single to consolidated filer status after the due date for filing the original returns, irrespective of whether the July 2009 version of RITA Rule § 5.06(A) is properly incorporated into the Bedford Heights Ordinances.

A. NYFF's change from single to consolidated filer status, which altered the way in which its profits and losses were apportioned and thereby altered the computation of New York's and NYFF's taxable income, constitutes a prohibited change in the "method of apportionment of net profits" under Section 173.15(a).

Both Section 173.15(a) and the December 2004 version of RITA Rule § 5.06(A) prohibit taxpayers from changing their "method of... apportionment of net profits" after the due date for the original return. (NYFF Supp. at 2, Stip. ¶¶ 7(c), 8(a)); (NYFF App'x at 23, 32). When

[1] Appellees do not separately restate the facts here but instead incorporate, and refer the Court to, the Statement of the Case and Facts in Appellees' First Merits Brief. *See* 9/18/15 Bedford Heights Merits Brief at 1-7.

NYFF as a collective entity tried to change New York's original single-filer election to a consolidated election, NYFF attempted a prohibited change in its "method of apportionment of net profits" because in so doing, NYFF changed how the profits and losses were apportioned on New York's original single-filer returns.

The "basic purpose of the consolidated return system is to reduce the effect that the separate existence of affiliated corporations has on the aggregate tax liability of the group." *See Federal Income Taxation of Corporations Filing Consolidated Returns*, § 1.01 (Matthew Bender, Rev. Ed.) (App'x to 4th Br. at 44). Indeed, "the ability to offset one member's losses against another member's income may be the single most important feature of filing on a consolidated basis." *Id.* (App'x to 4th Br. at 44).

Thus, under the federal consolidated tax return regime, "***unused losses of one member can offset the income of other members and thereby reduce the group's consolidated tax liability***." *Id.* §§ 41.01 and 41.03 ("A net operating loss... attributable to a member and arising in a consolidated return year is absorbed in consolidated return years as part of the group's consolidated taxable income or consolidated net operating loss.") (emphasis added) (App'x to 4th Br. at 1, 5); *see also Marvel Ent'mt, LLC v. Comm'r*, 2015 U.S. Tax. Ct. LEXIS 30, at *19-*20 (T.C. Jul. 21, 2015) (noting that 26 C.F.R. § 1.1502-79(a)(3) "***apportions a consolidated group's [consolidated net operating loss] to members of the group for the purpose of carrying back losses to separate return years***") (emphasis added); *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 834 (2001) (noting that the federal consolidated return regulations "expressly and exclusively defin[e]" net operating loss as the consolidated net operating loss reflected by the consolidated group of filers).

A concrete example demonstrates how filing on a consolidated basis alters the "apportionment of net profits" and losses among members of a consolidated group of taxpayers:

> P is the common parent of the P consolidated group, and P owns all of the only class of stock of subsidiaries S and T. The first step in determining consolidated taxable income or consolidated net operating loss is to compute the separate taxable income (or loss) of each member. For Year 1, P earns $100, S earns $50 and T incurs a $125 loss. ***The separate taxable incomes and losses are then combined, with the effect that current year losses of members are offset against the current taxable income of other members***. Thus, the P group's consolidated taxable income for Year 1 is $25 ($100, plus $50, minus $125). S's income results in a $50 positive investment adjustment to P's basis in the S stock, while T's loss results in a $125 negative investment adjustment to P's basis in the T stock.

Federal Income Taxation of Corporations Filing Consolidated Returns, § 41.01 (Matthew Bender, Rev. Ed.) (citing 26 C.F.R. § 1.1502-32) (emphasis added) (App'x to 4th Br. at 1-2). This example demonstrates that groups filing on a consolidated basis are free to apportion (within the confines of the consolidated return regulations) individual group members' profits and losses in an advantageous way that the individual group members could not do if they were filing on a single-filer basis.

Thus, when NYFF tried to change New York's single-filer election to a consolidated-filer election, NYFF was changing its "method of apportionment of net profits" by "offsett[ing]" certain NYFF group members' losses "against" other NYFF group members' "income." *Federal Income Taxation of Corporations Filing Consolidated Returns*, § 1.01 (Matthew Bender, Rev. Ed.) (App'x to 4th Br. at 1). Because of this change in apportionment, NYFF's change from single to consolidated filer status altered the computation of New York's original taxable income, resulting in a net profits tax refund claim of nearly $700,000. NYFF thus changed its "method of apportionment of net profits" when it tried to change from single to consolidated filer status. NYFF's attempt to do so is plainly prohibited by Section 173.15(a) and the December

2004 version of RITA Rule § 5.06(A), without regard to any of the constitutional or legal issues raised by NYFF.

Moreover, NYFF cited no authority to support its assertion that the "method of apportionment" phrase in Section 173.15(a) refers to the apportionment of taxable income among taxing jurisdictions. The *Jefferson Lines* case merely speaks of "apportionment disputes" that "center[] around specific formulas for slicing a taxable pie among several States in which the taxpayer's activities contributed to taxable value." *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 186 (1995). The case is inapposite and is not instructive on how the "method of apportionment of net profits" phrase at issue here should be interpreted. Indeed, the Court in *Jefferson Lines* was not addressing the issue of consolidated returns and how they affect the taxpayer's computation of taxable income. As the regulations and authorities detailed above show, the essence of the federal consolidated return regime is the advantageous ***apportionment of profits and losses*** among members of the consolidated group. Therefore, *Jefferson Lines* is not controlling and NYFF's interpretation of Section 173.15(a) is incorrect.

Finally, the BTA's conclusion that changing from single to consolidated filer status is not the same as changing the method of apportionment is based solely on RITA's amendment to Rule 5.06(A), which added "method of filing." But when RITA amended Rule 5.06(A) to include "method of filing," it was ***not*** conceding that such a change did ***not*** involve changing the method of apportionment. As set forth above, changing from single to consolidated filer status changes the taxpayer's method of apportioning net profits taxes.

Rather, RITA was simply clarifying the scope of the Rule to ensure that method of filing changes were included. As this Court is well aware, the legislature on occasion amends statutory language to clarify its original intent. Consequently, NYFF's argument that Bedford Heights'

Proposition of Law on cross-appeal would render the amendment to RITA Rule 5.06(A) "unnecessary and redundant" is incorrect. The amendment clarifies the original intent.

CONCLUSION

The overarching purpose of filing consolidated returns is to apportion profits and losses among the consolidated group in an advantageous manner unavailable to individual group members. Here, NYFF's attempt to change from single to consolidated filer status would have resulted in a net profits tax refund of nearly $700,000 (plus interest). This change constitutes a change in New York's original "method of apportionment of net profits," which is prohibited under Section § 173.15(a).

Accordingly, for the reasons stated above and in its First Merits Brief, Bedford Heights respectfully requests that this Court ***(a)*** affirm the decision of the BTA with respect to its conclusion that RITA Rule § 5.06(A) bars NYFF's refund claims; ***(b)*** reverse the decision of the BTA with respect to its conclusion that Section 173.15(a) does not bar NYFF from filing amended returns that change from single to consolidated filing; ***(c)*** reject NYFF's propositions of law; and ***(d)*** adopt Bedford Heights' proposition of law on cross-appeal.

DATED: November 5, 2015

Respectfully submitted,

/s/ *Matthew A. Chiricosta*

ANTHONY F. STRINGER (0071691)
Counsel of Record
MATTHEW A. CHIRICOSTA (0089044)
THOMAS R. O'DONNELL (0067105)
CALFEE, HALTER & GRISWOLD LLP
The Calfee Building, 1405 East Sixth Street
Cleveland, Ohio 44114
(216) 622-8200
(216) 241-0816 (fax)
AStringer@Calfee.com
MChiricosta@Calfee.com
TODonnell@Calfee.com

Counsel for Appellees/Cross-Appellants, Bedford Heights Income Tax Board of Review and City of Bedford Heights Income Tax Administrator

CERTIFICATE OF SERVICE

I certify that under S.Ct.Prac.R. 3.02(A)(3), the foregoing *Fourth Brief, Appellees'/Cross-Appellants' Second Merit Brief* was filed electronically on November 5, 2015 with the Ohio Supreme Court via the Court's e-Filing Portal. I also certify that under S.Ct.Prac.R. 3.11(C)(1), a copy of the foregoing *Fourth Brief, Appellees'/Cross-Appellants' Second Merit Brief* was served via email on the following on November 5, 2015:

STEPHEN K. HALL (0069009)
RICHARD C. FARRIN (0022850)
Zaino, Hall & Farrin LLC
41 S. High Street, Suite 3600
Columbus, Ohio 43215
(614) 326-1120
(614) 754-6368 (fax)
SHall@zhftaxlaw.com
RFarrin@zhftaxlaw.com

Counsel for Appellants,
New York Frozen Foods, Inc. and Affiliates

/s/ *Matthew A. Chiricosta*
One of the attorneys for Appellees/Cross-Appellants

Federal Income Taxation of Corporations Filing Consolidated Returns--Second Edition > *CHAPTER 41 Net Operating Losses and Capital Gains and Losses*

§ 41.01 Introduction

The members of a consolidated group have always been treated as a single entity for some purposes and as a collection of separate entities for other purposes.[1] The essence of single-entity treatment is the ability to combine the separate income and loss of each member into a single return for the consolidated group. Thus, unused losses of one member can offset the income of other members and thereby reduce the group's consolidated tax liability.[2] The ability of members to combine their separate income and loss in determining consolidated taxable income seems to compel additional consolidated return rules. Absent further integration rules (e.g., to prevent members from generating income or loss through intercompany transactions), the group's consolidated taxable income and tax liability will not be clearly reflected.[3]

Example:

Loss sharing. *P* is the common parent of the *P* consolidated group, and *P* owns all of the only class of stock of subsidiaries *S* and *T*. The first step in determining consolidated taxable income or consolidated net operating loss is to compute the *separate taxable income (or loss)* of each member.[4] For Year 1, *P* earns $100, *S* earns $50 and *T* incurs a $125 loss. The separate taxable incomes and losses are then combined, with the

[1] Examples of separate-entity treatment include Treas. Reg. § 1.1502-17(a) (each member can adopt its own method of accounting (although each member must adopt the common parent's annual accounting period under Treas. Reg. § 1.1502-76(a)) and Treas. Reg. § 1.1502-21(b) (each member retains its separate tax attributes when it leaves the group). Similarly, members with special status, such as a bank or insurance company, continue to determine their qualification for this status on a separate-entity basis. Single-entity treatment is illustrated by the intercompany transaction system under Treas. Reg. § 1.1502-13, and the investment adjustment system under Treas. Reg. §§ 1.1502-19, 1.1502-32 and 1.1502-33. For further discussion, *see* § 31.03[1][b] (balance between single- and separate-entity treatment).

[2] *See* Treas. Reg. §§ 1.1502-11; 1.1502-12. Limitations on the periods to which losses can be carried under IRC Sections 172 and 1212 encourage corporations with loss carryforwards to consolidate with income producing corporations that can use the losses currently in a consolidated return. For a discussion of the historic relationship between loss carryover periods and the attractiveness of consolidated return filing, *see* Blitman, *Consolidated Returns in the Federal Tax System*, 8 Nat'l Tax J. 260 (1955); Salem, *Advantages and Disadvantages of Filing Consolidated Returns: A Fresh Look*, 45 Taxes 141 (1967).

[3] For example, if members can share their income and loss within the consolidated return, special intercompany accounting rules under Treas. Reg. § 1.1502-13 are required to prevent the members from altering their consolidated taxable income through self-dealing. For further discussion, *see* Chs. 31 through 34. Similarly, the investment adjustment system under Treas. Reg. §§ 1.1502-19, 1.1502-32 and 1.1502-33 is designed to prevent the duplication of items already reflected in the consolidated return on the subsequent disposition of subsidiary stock, and to prevent the avoidance of dividend treatment, where appropriate, on distributions to shareholders. *See also* Treas. Reg. § 1.1502-36 (disallowance of stock loss); *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 54 S. Ct. 596, 78 L. Ed. 1127 (1934), (in the absence of an express provision, Congress could not have intended to permit "double deductions"); *Thrifty Oil Co. v. Commissioner*, 139 T.C. 198 (2012) (citing *Ilfeld* in adopting a similar approach; outside stock loss preceded the equivalent inside environmental remediation deduction and resulted in disallowance of the inside deduction); *Duquesne Light Holdings, Inc. v. Commissioner*, 106 T.C.M. 296 (2013) (similar). *See also* Treas. Reg. 75, Art. 34(c)(2) (1929), and former Treas. Reg. § 1.1502-34A (1994) (in a precursor to the investment adjustment system, the basis of a subsidiary's stock was reduced to the extent that its losses were availed of by the group and could not have been "availed of" by the subsidiary if it had filed separate returns); *Woolford Realty Co. v. Rose*, 286 U.S. 319, 52 S. Ct. 568, 76 L. Ed. 1128 (1932) (in a precursor to the SRLY rules, Congress was held to have not intended consolidated returns to permit manipulation of income through the absorption of separate return losses on a consolidated basis).

[4] *See* Treas. Reg. § 1.1502-11(a)(1). *See also* Treas. Reg. § 1.1502-21(e) (any excess of deductions over gross income is also referred to as the consolidated net operating loss or CNOL).

effect that current year losses of members are offset against the current taxable income of other members.[5] Thus, the *P* group's consolidated taxable income for Year 1 is $25 ($100, plus $50, minus $125). *S*'s income results in a $50 positive investment adjustment to *P*'s basis in the *S* stock, while *T*'s loss results in a $125 negative investment adjustment to *P*'s basis in the *T* stock.[6]

The ability to share losses exists for both current losses and losses incurred in one consolidated return year of the group and carried to other consolidated return years of the group.[7] Thus, if the group incurs a consolidated NOL attributable to one member, and earns consolidated taxable income in another year that is attributable to a different member, the loss may be carried over under applicable Code principles and used to offset the income. By contrast, a separate return corporation can generally only use the losses of another corporation following a transaction to which *IRC Section 381* applies.[8]

Nothing in the Code or regulations requires the members of a consolidated group to compensate the group, the parent, or any other member for the incurrence of income or loss that generates either tax liability or benefit for the group. Nevertheless, groups frequently enter into a *tax sharing agreement* that allocates the economic impact of the liability and benefit among themselves (e.g., the sharing of losses and other tax attributes). A tax sharing agreement is a private contractual arrangement, separate from the tax return elections and related filings, under which the members commit to compensate each other (or agree to not compensate each other) for the interaction of their tax attributes. By compensating a subsidiary that generates a loss that benefits other members, the subsidiary is able to retain some or all of the economic benefits of its attributes.[9] Tax sharing agreements are particularly common where members are regulated (e.g., public utilities and insurance companies), have minority shareholders, or otherwise have distinct interests, because an agreement

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5 Treas. Reg. § 1.1502-11(a).

6 Treas. Reg. § 1.1502-32. The investment adjustments are made as of the close of the year. Because the sale of a member's stock is not recharacterized as a sale of its assets, investment adjustments of this type are necessary to prevent the double inclusion of income and the double deduction of loss. For example, because *S*'s $50 of income increases the value of *S* stock by $50, if *P* sold the stock of *S* as a separate entity, the failure to provide for investment adjustments would result in *P* recognizing a $50 gain on the sale. The *P* group would be taxed twice on the same income—once when earned by *S* and a second time when the *S* stock was sold. For further discussion, *see* Ch. 51 (stock basis adjustments).

7 In addition, the regulations generally permit the sharing of losses incurred by a corporation in a separate return year (or SRY), if the corporations were members of the same affiliated group for each day of the year in which the loss was incurred. For example, if *P* and *S* are affiliated in Year 1, but file separate returns, and either corporation incurs a loss that can be carried forward to Year 2, the loss can offset the other affiliate's income in Year 2 if they elect to file a consolidated return for that year. Of course, the amount of loss (either current or carryover) absorbed in a consolidated return year is limited to the consolidated taxable income for that year. For further discussion, *see* § 41.03[1] (offset current year separate income of other members). Special rules apply to losses arising in other types of SRYs (referred to as separate return limitation years, or SRLYs), which may or may not limit the use of the losses to offset income of other members. For further discussion, *see* Ch. 42 (special limitations on tax attributes).

8 For example, IRC Section 332 liquidations, and IRC Section 361 transfers pursuant to a reorganization described in IRC Section 368(a)(1)(A), (C), (D), (F) or (G).

9 While the tax return elections and other filings might affect tax attributes such as stock basis, a tax sharing agreement affects cash flow around the group. For example, if *P* offsets $100 of income with *S*'s $100 of deductions, the group's consolidated tax liability will be $0. The group may adopt a tax sharing agreement requiring *P* to compensate *S* for the loss absorption. Under a typical agreement, if the group otherwise incurs a 35% rate of taxation, *P* would pay *S* $35 in the year of absorption as a surrogate for the tax it would have otherwise incurred and to compensate *S* for the tax benefit it may otherwise have utilized in a subsequent year. Another approach might be for *P* to pay nothing to *S* in the year of absorption, but for *P* to pay *S* in a later year when *S* could have absorbed the attribute if *S* had filed separate returns (assuming that it is still a member at that time). Still another method might be for *P* to compensate *S* in the year of absorption, but reduce the compensation below $35 to reflect the expected present value to *S* of the attribute assuming *S* filed separate returns, or to reflect the extent *S* is perceived in the year of absorption to be unlikely to absorb the loss on its own in a later year. Still other methods exist, and can be tailored to the particular needs of each group.

permits the member generating the attribute (and thereby its minority shareholders, etc.) to effectively retain the benefit of the attribute.[10]

Because losses (and other tax attributes) attributable to each member often can be carried to its separate return years ending before or beginning after the period it is a member, an understanding of the applicable consolidated return regulations can be very important in the mergers and acquisitions context. Tax attributes are frequently very valuable assets of a loss member that are reflected in the purchase price. In particular, a tax sharing agreement is important to ensure the proper allocation of economic benefit from tax attributes between selling and buying shareholders. For further discussion, including possible characterization of payments, *see § 41.04[9]* (ownership of refunds where no agreement exists between the members of a consolidated group regarding the sharing of tax refunds), Chapter 54 (allocation of tax liability), and Chapter 71 (tax sharing considerations).

This Chapter is divided into separate, but interrelated, topics. First, the basic operating rules applicable to computation of current consolidated NOLs are described.[11] To the extent that a current loss is not absorbed, the next topic is how the excess is carried back and forward to other (consolidated or separate return) taxable years.[12] Finally, this Chapter discusses the comparable rules for capital gain net income and net capital loss.[13]

Principal limitations on the absorption of net operating losses and net capital losses are discussed separately in Chapter 42 (special limitations on tax attributes). Some of these limitations apply solely in the consolidated return context.[14] Most, however, arise under the Code and apply equally to all corporations.[15] Although these limitations are integral to the basic discussion of loss absorption and carrying to other years, the numerous special rules warrant separate discussion. Concerns with losses under the alternative minimum tax are also discussed separately in § 61.06.

The current format of the consolidated return loss regulations was first comprehensively overhauled in 1966.[16] Comprehensive revisions to basic rules were subsequently adopted in conjunction with the issuance of regulations applying *IRC Sections 382* and *383* in the consolidated group and controlled group contexts. These revisions were proposed in January 1991 as a complete revision of the consolidated return operating rules for losses, to provide rules for determining the limitations under *IRC Sections 382* and *383* for members of consolidated groups, and to coordinate these limitations

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[10] To the extent a less than 100 percent owned subsidiary's loss is absorbed by the group, and the subsidiary is paid for the use of its loss, the minority shareholders have effectively transferred their interest in the loss to the group's other shareholders in what could be characterized as loss trafficking. *See generally* H.R. Rep. No. 391, 100th Cong., 1st Sess. 1091–92 (1987) (a House proposal that was never adopted, to deny consolidation with respect to the percentage of a subsidiary's income or loss allocable to stock owned by nonmembers).

[11] *See* Treas. Reg. § 1.1502-21.

[12] Treas. Reg. §§ 1.1502-15, 1.1502-21 and 1.1502-23 provide the rules to determine the carryover and carryback of consolidated NOLs.

[13] *See* Treas. Reg. §§ 1.1502-22 and 1.1502-23.

[14] Examples of special consolidated return rules are Treas. Reg. §§ 1.1502-15, 1.1502-21(c) and 1.1502-22(c) (SRLY rules); Treas. Reg. §§ 1.1502-21(d) and 1.1502-22(d) (CRCO rules); Treas. Reg. § 1.1502-36 (unified loss rule) Examples of separate return rules that have been adapted to the consolidated return context are Treas. Reg. §§ 1.1502-90 through 1.1502-99 (consolidated return applications of IRC Sections 382 and 383). The consolidated return regulations have almost always included special limitations. Early examples include L.0. 1113, III-2 CB 36 (1924), and GCM 3266, VII-1 CB 205 (1928). Early court cases include *Woolford Realty Co. v. Rose*, 286 U.S. 319, 52 S. Ct. 568, 76 L. Ed. 1128, 1932-1 CB 154, and *Planters' Cotton Oil Co. v. Hopkins*, 286 U.S. 332 (1932).

[15] Examples of limitations under the Code applicable to all corporations are IRC Sections 267, 269, 382–84, 482, 1091 and 1092.

[16] TD 6894, 1966-2 CB 362. For an excellent, contemporaneous description of the rules, *see* Salem, *How to Use Net Operating Losses Effectively Under the New Consolidated Return Regulations*, 26 J. Tax'n 270 (1967).

for controlled group members as provided in *IRC Section 382(m)(5)*.[17] The regulations were adopted in June 1996 on a temporary basis without significant modification from the proposed rules despite intensive commentator input.[18] These regulations were finalized in June 1999, without significant modifications to the basic operating rules, but with significant modifications to the limitations on loss absorption.[19]

When the temporary regulations were originally proposed, they were generally to be effective based on their issuance date of January 29, 1991 (and other transitional rules for their application). Because of this effective date, and the limitations of *IRC Section 1503(a)* on effective dates, uncertainty arose whether the prior rules or the proposed rules (if adopted) would determine their use of losses for consolidated return years ending on or after January 29, 1991.[20] The temporary regulations adopted the proposed regulations generally for consolidated return years beginning on or after January 1, 1997.[21] They also contain rules for their application to consolidated return years ending on or after January 29, 1991, and beginning before January 1, 1997. The final regulations generally apply in taxable years for which the due date of the consolidated return is after June 25, 1999. For more detailed discussion of the effective dates, *see* *§ 41.08* (effective dates).

The government continues to refine the relationship of members to consolidated losses. For example, the potential for loss to be duplicated within a consolidated return was revisited in the wake of the *Rite Aid*, and this in turn led to aspects of the debt discharge rules being revisited in 2003.[22] Moreover, rules relating to the application of *IRC Sections 108* and *1017* to a consolidated group were revised. In addition, new rules were adopted for members to not participate pro rata in all events that affect the reduction, absorption, carrying over, and expiration of contributions to a consolidated loss.[22.1]

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17 *See* CO-132-87, 1991-1 CB 728 (consolidated group IRC Sections 382 and 383); CO-78-90, 1991-1 CB 757 (basic consolidated return rules); CO-77-90, 1991-1 CB 749 (controlled group IRC Section 382); ***Notice 91-27, 1991-2 CB 629*** (amendments to the proposed rules).

18 *See* ***TD 8677, 1996-2 CB 119*** (basic consolidated return rules); ***TD 8678, 1996-2 CB 134*** (consolidated group IRC Sections 382 and 383); ***TD 8679, 1996-2 CB 25*** (controlled group IRC Section 382). The regulations were reproposed in conjunction with the temporary regulations. *See* CO-24-96, 1996-2 CB 437 (basic consolidated return rules); CO-25-96, 1996-2 CB 439 (consolidated group IRC Sections 382 and 383); CO-26-96, 1996-2 CB 440 (controlled group IRC Section 382). Comments on the proposed and temporary regulations are cited throughout this chapter. For an early commentary, *see* Sheppard, *IRC Section 382 and Consolidated Returns*, 40 Tax Notes 895 (Aug. 29, 1988).

19 *See* ***TD 8823, 1999-2 CB 34*** (basic consolidated return rules); ***TD 8824, 1999-2 CB 62*** (consolidated group IRC Sections 382 and 383); ***TD 8825, 1999-2 CB 19*** (controlled group IRC Section 382).

20 *See* IRC Section 1503(a) ("In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under IRC Section 1502 prescribed before the last day prescribed by law for the filing of such return").

21 That is, losses and deductions of a member (including SRLY losses) carried to consolidated return years beginning on or after January 1, 1997 are governed by the temporary regulations, regardless of the year in which the loss or deduction was recognized, and regardless of when the member with the SRLY loss became a member of the group.

22 For detailed discussion of these issues, *see* *Rite Aid Corporation and Subsidiary Corp. v. U.S.*, 255 F.3d 1357 (Fed. Cir. 2001), reh'g denied, 2001 U.S. App. LEXIS 23207 (Fed. Cir. October 3, 2001) (holding that former Treas. Reg. § 1.1502-20(c)(1)(iii) (2008) was invalid as a bar on loss duplication); Chapters 72 (loss disallowance), 73 (loss duplication), 73A (unified loss rule) and 74 (insolvent members). *See also* Pub. L. No. 108-357, § 844 (2004) (amending IRC Section 1502 to confirm that the Secretary may prescribe rules different from the Code, but prohibiting former Treas. Reg. § 1.1502-20(c)(1)(iii) (as in effect on January 21, 2001) from being construed as applicable to the factual situation in *Rite Aid*).

22.1 *See* Treas. Reg. § 1.1502-21(b)(2)(iv)(B)(2) (generally requiring a recomputation of the percentage of the CNOL attributable to each member as of immediately after a carryback by a member to its separate return year, a member's realization of excluded COD income that reduces attributes pursuant to IRC Sections 108 and 1017 and Treas. Reg. § 1.1502-28, a consolidated return year in which a member leaves the group, or a reduction of the NOL of a member pursuant to Treas. Reg. § 1.1502-36 where the member remains in the group).

§ 41.03 Current Year Separate Net Operating Losses (NOL) of Members

[1] Offset Current Year Separate Income of Other Members

A net operating loss (NOL) attributable to a member and arising in a consolidated return year is absorbed in consolidated return years as part of the group's consolidated taxable income or consolidated net operating loss. The first step in determining consolidated taxable income or consolidated net operating loss is to compute the *separate taxable income (or loss)* of each member.[34]

A member's separate taxable income (or loss) is computed for this purpose with several consolidation adjustments.[35] For example, capital gains and losses, and *IRC Section 1231* gains and losses, are not taken into account in computing separate taxable income (these items are instead taken into account on a consolidated basis), and intercompany transactions are taken into account based on intercompany accounting (i.e., items deferred under *Treas. Reg. § 1.1502-13* are not included in separate taxable income until they are taken into account by the group).[36] For purposes of this computation, any NOL carryovers or carrybacks to the taxable year are also not taken into account (again, these items are instead taken into account on a consolidated basis).[37] The separate taxable incomes and NOLs are then combined, with the effect of any current year losses of members being offset against the current taxable income of other members.[38]

The consolidated return regulations do not permit the separate NOL carryover or carryback of a member to be applied directly against its own taxable income included in the consolidated return. It does not matter whether the NOL arose in a consolidated return year or in a separate return year. Even NOLs arising in separate return years that are carried over or back by the loss member are deducted as part of the consolidated NOL ("CNOL") deduction that offsets the income of the group as a whole.[39] The regulations provide that all NOLs from the same taxable year generally are absorbed on a pro rata basis.[40]

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34 *See* Treas. Reg. §§ 1.1502-11(a)(1) and 1.1502-21(e) (consolidated net operating loss).

35 *See* Treas. Reg. § 1.1502-12.

36 *See* Treas. Reg. §§ 1.1502-11(a)(3) and (4); 1.1502-12(a), (j) and (k).

37 Treas. Reg. §§ 1.1502-11(a)(2); 1.1502-12(h).

38 Treas. Reg. § 1.1502-11(a)(1).

39 Treas. Reg. §§ 1.1502-11(a)(2); 1.1502-12(h); 1.1502-21(a). But the portion of any consolidated NOL that is absorbed must be associated with the members to which it is attributable for various consolidated return purposes. *See, e.g.,* Treas. Reg. §§ 1.1502-21(b)(2) (if any portion of the consolidated NOL that is attributable to a member may be carried to a separate return year of the member, the amount that is attributable to the member is apportioned and carried to the separate return year); 1.1502-21(c) (a member's SRLY limitation on NOLs carried to consolidated return years is based on the member's contribution to consolidated taxable income, and its losses and deductions are taken into account for this purpose); 1.1502-33(b)(1) (deficits in E&P of a member "tier up" to reduce the E&P of other members that own stock of the member with the deficit); 1.1502-33(d) (taxpayers may elect to take into account the reduction in consolidated tax liability resulting from absorption of a member's losses and credits in allocating the liability among the members).

A subsidiary's losses reduce the basis of its stock owned by members pursuant to Treas. Reg. § 1.1502-32(b)(3)(i) and (iii), based on the loss being absorbed or expiring, in order to achieve a single-entity effect for the consolidated group. For further discussion, *see* § 51.06[1]. *See also* TAM 8827001 (Mar. 31, 1988) (Reg. §§ 1.1016-6(a) and 1.1502-80 require a parent to make a negative basis adjustment to a subsidiary's stock as a result of losses incurred by the subsidiary in a separate return year and carried back to a prior consolidated return year, citing *Ilfeld* and *Wyman-Gordon* principles). If the subsidiary's stock is sold before its loss is absorbed or expires, the selling group should be entitled to any loss on the subsidiary's stock that corresponds to the subsidiary's own loss because the group also incurred the loss through its investment in the subsidiary's stock. The selling group's stock loss will be duplicated if the subsidiary subsequently absorbs its own loss in a later consolidated return year of a buying group (the same economic loss is taken into account once by the selling group through the stock loss, and again by the buying group through the subsidiary's own absorption, although absorption in the buying group generates a negative investment adjustment that might have the effect of recapturing the second loss). The relationship between duplicated loss and repeal of the *General Utilities* doctrine in 1986 was first addressed by former Treas. Reg. § 1.1502-20(c)(1)(iii) (2008), which denied stock loss to the extent of potential duplication with the subsidiary's own loss but was held to be invalid. *See Rite Aid Corp. and Subsidiary Corps. v. U.S.*, 255 F.3d 1357 (Fed. Cir. 2001), reh'g denied, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001). This approach was replaced by Treas. Reg. § 1.1502-36. For various common law arguments on loss duplication within a single consolidated group, *see, e.g.*, ILM 200423027 (May 17, 2004); ILM 200431014 (May 17, 2004); FSA 200238045 (Aug. 16, 2002); FSA 200205003 (Oct. 5, 2001), supplementing FSA 200043007 (July 22, 2000); FSA 200023016 (Mar. 1, 2000); TAM 201419013 (Nov. 22, 2013). For further discussion, *see* Chapters 72 (loss disallowance), 73 (loss duplication) and 73A (unified loss rule).

[40] Treas. Reg. § 1.1502-21(b)(1). *See also* Treas. Reg. § 1.1502-21(c)(1)(iii), *Ex. 2.* For amendments, *see* ***TD 9089, 2003-2 CB 906***, and ***TD 9192, 2005-1 CB 866*** (final regulations with minor amendments). For taxable years for which the due date of the consolidated return is on or before June 25, 1999, *see* former Treas. Reg. § 1.1502-21T (1999). For taxable years beginning before January 1, 1997, *see* Treas. Reg. § 1.1502-21A.

Recognizing that the current consolidated return regulations do not expressly provide a rule for pro rata absorption of each member's contribution to the CNOL for a year, as computed under Treas. Reg. § 1.1502-21(b)(2)(iv), proposed regulations would adopt ***Prop. Treas. Reg. § 1.1502-11(e)(1) (2015)*** to clarify that the absorption of members' losses to offset income of other members in the consolidated return year is generally made on a pro rata basis (consistent with the pro rata approach to absorption of losses from taxable years ending on the same date that are carried back or forward under Treas. Reg. § 1.1502-21(b)). *See* REG-101652-10, 2015-26 IRB 1197. This rule would apply in consolidated return years beginning on or after the date final regulations are published in the Federal Register.

The regulations also provide that the other provisions of the Code and regulations apply in addition to IRC Section 172, and cite IRC Section 382(l)(2)(B) as an example (providing that, as between losses carried from the same year, losses subject to limitation under IRC Section 382 are absorbed before unlimited losses). *See* Treas. Reg. § 1.1502-21(b)(1). *See also* IRC Section 384(e)(2) (similarly providing that, as between losses carried from the same year, losses subject to limitation under IRC Section 384 are absorbed before unlimited losses). For further discussion, *see* §§ 41.05[1] (general rules, including IRC Section 381(c)(1)), 42.05[1][b] (overview of consolidated groups), 42.05[4][a] (amount of IRC Section 382 limitation) and 42.06[2] (basic rules and definitions under IRC Section 384). The special rules applicable to relinquishing the entire carryback period with respect to losses attributable to insolvent financial institutions, under Treas. Reg. § 301.6402-7, are also cross referenced. Treas. Reg. § 1.1502-21(b)(3)(ii). For further discussion, *see* § 41.04 (carrybacks of CNOLs).

If a loss member ceases to be affiliated with a SRLY subgroup, an additional stacking rule provides that the amount of the member's remaining SRLY NOLs or NCLs from a specific year is determined pursuant to the principles for apportioning a CNOL or CNCL to a departing member (*e.g.*, multiplying the aggregate of the unabsorbed loss of the SRLY subgroup members for that year by a fraction, the numerator of which is the aggregate of such losses for that year of the SRLY subgroup members when they joined the group). *See* Treas. Reg. § 1.1502-21(c)(2)(vii); ***TD 9089, 2003-2 CB 906*** (temporary amendments to Treas. Reg. § 1.1502-21(c)(2)(vii)) and ***TD 9192, 2005-1 CB 866*** (final regulations with minor modifications). The unabsorbed loss of the SRLY subgroup is the amount not absorbed by the group as of the end of the taxable years in which the loss member leaves the group. For further discussion of the SRLY subgroup rules, *see* § 42.02. The purpose for the subgroup rule is unclear, but appears to responds to comments. *See* Banks, Madden & Yates, Letter to Commissioner Rossotti (November 16, 1998); *reprinted in* 98 TNT 227-21 (LEXIS, Fedtax Library, TNT File)(suggesting absorption rules for subgroups).

The subgroup rule appears to presume *pro rata* absorption of losses within the subgroup, which might be incorrect in light of inconsistent limitations on the various subgroup losses (*e.g.*, IRC Sections 382(1)(2)(b) and 384(e)(2) and the greater flexibility under Treas. Reg. § 1.1502-21(b)(2)(iv) that applies outside the subgroup context). The general *pro rata* rule for CNOLs under Treas. Reg. § 1.1502-21(b)(1) specifically incorporates other Code rules providing for special absorption rates in particular circumstances, and this flexibility is overlooked in the subgroup context. The subgroup rule has additional flaws. For example, as discussed above, loss absorption must be associated with the members for various consolidated return purposes, apart from leaving a SRLY subgroup. Thus, if a single share of subsidiary stock is sold in a transaction to which IRC Section 1001 applies, how are the subsidiary's Treas. Reg. § 1.1502-32 adjustments to reflect the absorption of subgroup losses?

Example:

Pro rata absorption of loss. P owns all of the stock of *S*. In Year 1, *P* and *S* contribute equally to a $200 CNOL. In Year 2, *S* earns $100 while *P* breaks even. Of the group's $100 CNOL deduction for Year 2, $50 is attributable to *P*'s loss from Year 1 and $50 is attributable to *S*. Thus, if *S* leaves the group at the end of Year 2, $50 of the remaining $100 CNOL carryover is apportioned to *S*'s first separate return year.

Current income and losses of all members must offset each other in the consolidated computations before any carryovers or carrybacks can be absorbed on a consolidated basis. Thus, as a member with a separate loss creates no NOL carryover if other members have offsetting income, and a member with separate income cannot absorb any NOL carryovers or carrybacks to the year if the group has a consolidated NOL for the year (i.e., current loss must be absorbed first, even if a member could have absorbed carryovers or carrybacks on a separate return basis).[41]

If a member leaves the consolidated group during a year in which it generates items of deduction or loss, and these items are not fully absorbed as part of the group's consolidated computations under Treas. Reg. §§ 1.1502-11 and 1.1502-12 for that year, they are treated like items arising in prior consolidated return years. That is, after the amounts are first included in the consolidated computations for the current year, they are available for reduction under IRC Section 108(a) and Treas. Reg. § 1.1502-28, or carryback to prior consolidated or separate return years (e.g., as part of the group's CNOL carryback from the year of departure).[42] To the extent not fully absorbed or reduced in this process, the remaining amounts are available for apportionment and carryover to the member's subsequent separate return years.[43] Only the amounts not absorbed by the group in the current year, or a prior consolidated or separate return year, or reduced under IRC Section 108(a) and *Treas. Reg. § 1.1502-28*, can be apportioned to the member for carryover to its subsequent separate return

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[41] *See, e.g.,* ***Rev Rul 66-91, 1966-1 CB 54*** (in Year 1 there was a consolidated CNOL, and no portion of a separate return Year 4 NOL need be carried back to the prior consolidated return Year 1 because there was no consolidated taxable income); *Phinney v. Houston Oil Field Material Co.*, 252 F.2d 357 (5th Cir. 1958) (a separate return Year 1 NOL cannot be carried to consolidated return Year 3 to first offset the member's own income and thereby increase the Year 3 consolidated NOL attributable to other members for carryback to prior consolidated return years, because the NOL can only be carried to a year if there is consolidated taxable income for the year); *Foster v. Comm'r*, 25 T.C.M. 1390 (T.C. 1966), *aff'd on other issues sub nom.*, *Likins-Foster Honolulu Corp. v. Comm'r*, 417 F.2d 285 (10th Cir. 1969), cert. denied, ***397 U.S. 987, 90 S. Ct. 1117, 25 L. Ed. 2d 395 (1970)*** (unless there is consolidated taxable income before any NOL carryover, there is no income against which to apply even a separate return carryover of a member having separate income); TAM 8916001 (Dec. 28, 1988) (a subsidiary's separate return NOLs, carried over to a consolidated return year and potentially includible in the CNOL deduction for the year, are not included in the group's determination of its consolidated NOL for the year and, therefore, cannot be carried back to a separate return year of the parent). *See also* TAM 8946006 (July 31, 1989) and TAM 8946007 (July 31, 1989) (summary of Treas. Reg. § 1.1502-21A(b) operating rules). For purposes of the current regulations, the preamble to the 1991 proposed regulations observed:

> The present consolidated return rules reflect the general principles of IRC Sections 172 and 1212 regarding the order in which items of loss and deduction are allowed. For example, any consolidated net operating loss carried to a year generally is allowed only after any deductions arising in the year and after any capital loss arising in or carried to the year. The proposed amendments preserve these relationships while restating the rules of §§ 1.1502-21(a) and (b) and 1.1502-79 and relocating the rules in § 1.1502-21(a) and (b). IRC Section 1.1502-21 is re-designated "Net operating losses" to signify that all of the basic operating rules are contained in one Section, instead of only those rules applicable to the consolidated net operating loss deduction. Except as described below, these amendments to the rules relating to carryovers and carrybacks are generally intended to simplify, but not change, the rules of present law.

CO-78-90, 1991-1 CB 757.

[42] For consolidated net operating losses, *see* Treas. Reg. § 1.1502-21(b) and 1.1502-21T(b) (2003). Comparable principles are applied under Treas. Reg. § 1.1502-22(b) for consolidated net capital losses.

[43] *See* Treas. Reg. §§ 1.1502-21(b)(2). For the history of amendments, *see* ***TD 9089, 2003-2 CB 906*** (temporary regulations), and ***TD 9192, 2005-1 CB 866*** (final regulations with minor amendments).

years.[44] For a detailed discussion of how items are carried to prior and subsequent years, as well as alternatives, *see* *§§ 41.04[2]* (carrybacks) and 41.05[2] (carryovers).

[2] Computation of Consolidated NOL (CNOL)

The *consolidated net operating loss* (CNOL) for a year is any excess of deductions over income in the determination of consolidated taxable income.[45] The group's consolidated taxable income or CNOL is computed by first combining the separate taxable incomes (or losses) of the members, and then adjusting for certain items excluded in that computation.[46] Among the items excluded from the income computation that are restored in computing the CNOL for the year are (i) capital gain net income,[47] (ii) *IRC Section 1231* net losses,[48] (iii) the charitable contributions deduction,[49] (iv) the dividends received deduction,[50] and (v) the deduction under *IRC Section 247* for dividends paid on certain preferred stock of public utilities.[51]

The amount of current deductions and losses for any consolidated return year is subject to the following limitations:

(1) Limitations on use of losses and deductions of a subsidiary that is disposed of outside the group during a consolidated return year;[52]

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44 For amounts arising in prior years and carried forward to the year of departure, the priority of consolidated return absorption is explicitly provided in Treas. Reg. §§ 1.1502-21(b)(2)(i) and (b)(2)(ii)(A).

While there is an explicit rule for absorption of carryovers before apportionment, current year amounts arising in the year of departure implicitly have a comparable absorption requirement based on the general operation of the consolidated return rules. The departing member's items attributable to the period of its inclusion in the consolidated return through the date of departure must be reflected in that year's consolidated return computations. *See* Treas. Reg. §§ 1.1502-11, 1.1502-12, and 1.1502-76(b)(2). These amounts can only be carried to other consolidated or separate years to the extent provided by the regulations. *See* Treas. Reg. §§ 1.1502-21(b) and (e). Thus, for ordinary deductions to be carried forward to a later year, there must be a CNOL susceptible to carryover and apportionment. There is no need for an explicit rule prioritizing the group's absorption of current year items for the year of departure, because this treatment automatically results from the general mechanics for determining whether the group has a CNOL for the year that is susceptible to apportionment. For the determination of whether some or all of the consolidated amount is attributable to the departing member, *see* Treas. Reg. § 1.1502-21(b)(2)(iv). *See also* Treas. Reg. § 1.1502-21(f)(1) (for purposes of Treas. Reg. § 1.1502-21, any reference to a corporation, member, common parent, or subsidiary, includes, as the context may require, a reference to a successor or predecessor, as defined in § 1.1502-1(f)(4)). A separate return year includes a taxable year for which the former member files a separate return or for which it joins in the filing of a consolidated return by another group. *See* Treas. Reg. §§ 1.1502-1(e); 1.1502-21(f).

45 Treas. Reg. § 1.1502-21(e).

46 Treas. Reg. § 1.1502-11(a). Under the regulations in effect for taxable years beginning before January 1, 1997, any CNOL was computed separately from consolidated taxable income. *See* Treas. Reg. § 1.1502-21A(f). Consolidated taxable income was computed in the same manner, but the CNOL was computed with slightly different adjustments: (i) the separate taxable income (as determined under Treas. Reg. § 1.1502-12) of each member of the group, computed without regard to any deduction under IRC Section 242; (ii) any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977); (iii) any consolidated IRC Section 1231 net loss; (iv) any consolidated charitable contributions deduction; (v) any consolidated dividends received deduction (determined under Treas. Reg. § 1.1502-26 without regard to Treas. Reg. § 1.1502-26(a)(2)); and (vi) any consolidated IRC Section 247 deduction (determined under Treas. Reg. § 1.1502-27 without regard to Treas. Reg. § 1.1502-27(a)(1)(ii)).

47 *See* Treas. Reg. § 1.1502-22.

48 *See* Treas. Reg. § 1.1502-23.

49 *See* Treas. Reg. § 1.1502-24.

50 *See* Treas. Reg. § 1.1502-26.

51 *See* Treas. Reg. § 1.1502-27.

52 *See* Treas. Reg. § 1.1502-11(b) and (c). For further discussion, *see* Chapters 73 and 74.

(2) Statutory provisions for disallowance or limitation on use of losses and deductions by corporations in the consolidated return context, such as *IRC Section 1503(d)* and *(f)*;[53]

(3) Limitations on the use of *built-in* amounts;[54]

(4) Statutory provisions for disallowance or limitation on use of losses by all corporations, such as *IRC Sections 269*, *382*, *384* and *482*;[55]

(5) Elimination of NOLs as a result of a corporation ceasing to exist in a transaction to which *IRC Section 381(a)* does not apply;[56]

(6) Apportionment to a member for carryover to its own separate return years (including the consolidated return years of another group);[57] and

(7) Judicially determined limitations on the use of losses and deductions.[58]

[3] IRC Section 1503(d) Dual Consolidated Losses

[a] Introduction

Before the enactment of *IRC Section 1503(d)* in 1986, it was possible for a so-called dual resident corporation ("DRC") to use its NOLs to offset income in both a foreign country and the U.S.[59] A corporation created or organized in the U.S. (or under the laws of the U.S. or a state) is referred to as a U.S. corporation (or U.S. resident corporation).[60] The U.S. taxes every U.S. corporation on its worldwide income, and generally allows it to join with other commonly owned U.S. corporations in the filing of a consolidated return.

Some countries use other criteria to identify resident corporations for tax purposes (e.g., based on the corporation being managed or controlled in the country). If a foreign country treats a corporation as a resident, it typically also taxes the corporation's worldwide income. In some cases, the foreign country allows losses of a resident corporation to reduce or eliminate tax on the income of other commonly owned resident corporations. Moreover, a corporation can be incorporated in both the U.S. and a foreign jurisdiction. For example, a U.S. owner of a foreign entity can also incorporate that entity in the U.S., and many foreign countries will still consider the entity incorporated in that foreign country. These entities are referred to as dual incorporated companies or *DINCs*.[61]

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[53] These limitations are discussed in §§ 41.03[3] (IRC Section 1503(d) dual consolidated losses) and 41.03[4] (IRC Section 1503(f) limitation on losses in connection with subsidiary preferred dividends).

[54] *See* Treas. Reg. § 1.1502-15; IRC Sections 382(h) and 384. For further discussion, *see* §§ 41.03 (built-in loss), and 42.05[4][d] (IRC Section 382(h)), 42.06 (IRC Section 384) and Chapter 71 (acquisitions and dispositions of subsidiaries).

[55] These limitations are discussed more fully in Chapter 42 (special limitations on tax attributes).

[56] For further discussion, *see* § 41.05[7] (disappearing members and disappearing loss).

[57] For further discussion, *see* § 41.04[2] (apportionment of CNOL to members).

[58] For further discussion of these limitations, *see* § 42.09 (general Code limitations). For further discussion of double deductions, *see* §§ 51.04[2][b] and Chapter 73 (loss duplication).

[59] *See* ***P.L. 99-514***, § 1249 (1986); ***P.L. 100-647***, § 1012(u) (1988).

[60] *See* IRC Section 7701(a)(4).

[61] A DINC is treated as an includible corporation. A business entity (including an entity that is disregarded as separate from its owner under Treas. Reg. § 301.7701-2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the U.S., or under the law of the U.S. or any State. Accordingly, a business entity that is created or organized both in the U.S. and in a foreign jurisdiction is a domestic entity. Treas. Reg. § 301.7701-5(a). If the entity is classified as a corporation, it will be treated as an includible corporation. The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or noncorporate classification. *See* Treas. Reg. §§ 301.7701-2 and 301.7701-3. For example, an entity organized under the laws of a foreign

A corporation therefore may be a dual resident for tax purposes. A DRC is generally taxable in both countries on its worldwide income. In addition, if the foreign country has provisions that, like the U.S. consolidated return provisions, permit commonly controlled resident corporations to combine their income and losses, a DRC might be able to effectively use its losses twice—once against the income of U.S. affiliates (other than affiliates that are themselves DRCs) and a second time against the income of affiliates that are resident only in the other country.

Corporate groups might isolate expenses in a DRC so that, viewed in isolation, the DRC was operating at a loss for tax purposes. This isolation of expenses would effectively allow the consolidation of the loss of the DRC with two different profitable corporations, one in the U.S. and one in the foreign country. The profitable corporations, however, would report their income to only one country. *IRC Section 1503(d)* was enacted to eliminate this perceived "double dipping" benefit.[62] For taxable years beginning after 1986, the NOL of a domestic corporation that is subject to an income tax of a foreign country, either on its worldwide income or on a residence basis, is not available to reduce the income of other affiliates for the taxable year (or any other taxable year).[63]

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country as a public limited company, and under the laws of a U.S. state as a limited liability company, is classified as a corporation for U.S. Federal tax purposes under Treas. Reg. §§ 301.7701-2 and-3. Accordingly, the entity is a domestic corporation because it is organized under the laws of a U.S. state. *See* Treas. Reg. § 301.7701-5(b), *Ex. 1*.

[62] S. Rep. No. 313, 99th Cong., 2d Sess. 419–21 (1986); H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-656–58 (1986). The 1992 regulations, as discussed below, describe the opportunity as follows:

> IRC 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 in 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 (upon a repatriation of earnings), there are timing benefits of double dipping that the statute was intended to prevent.

TD 8434, 1992-2 CB 240. This provision originated in the Senate, in a version of IRC Section 1503(d) that would have prohibited a DRC from consolidating with a U.S. group for all purposes if a foreign party could have benefited from the loss (unless the foreign party's income was or would have been subject to U.S. tax). *See S*. Rep. No. 313, 99th Cong., 2d Sess. 421–23 (1986). The focus of the Senate was on foreign-owned, DRCs. The final version differed from the Senate version for two reasons. First, "double dipping" was perceived to be unsound tax policy. Second, Congress did not wish to discriminate against foreign-owned entities, and concluded that the final version did not discriminate against foreign owners of U.S. entities in relation to U.S. owners. Congress nevertheless directed that IRC Section 1503(d) override any conflicting treaties. *See* H.R. Conf. Rep. No. 814, 99th Cong., 2d Sess. II-657–58 (1986).

IRC Section 1503(d)(3) and (4) were added by the Technical and Miscellaneous Revenue Act of 1988. *See* ***P.L. 100-647***, § 1012(u) (1988). Congress became aware that foreign law might permit foreign branches of U.S. corporations to consolidate with foreign affiliates of the U.S. corporation and this would present the same opportunity for double-dipping. *See* S. Rep. No. 445, 100th Cong., 2d Sess. 307–08 (1988). IRC Section 1503(d)(3) eliminates this possibility by authorizing regulations to provide that any loss of a *separate unit* of a domestic corporation is subject to the limitations of IRC Section 1503(d) as if the unit were a wholly owned subsidiary of the domestic corporation. Because avoidance might occur by stuffing income-producing assets into a DRC after a loss is sustained (and generally after the entity has ceased to be subject to tax in the foreign jurisdiction), IRC Section 1503(d)(4) was added to authorize regulations to prevent this as well.

[63] IRC Section 1503(d)(1) and (d)(2)(A). For more in-depth discussion of the dual consolidated loss rules, *see, e.g.,* Shay & Watson, *Final Dual Consolidated Loss Regs. Still Have Some High Hurdles*, 4 J. Int'l Tax'n 52 (1993); Magee, Farmer & Katcher, *The Final Dual Consolidated Loss Regulations: Reassessing the Congressional Mandate*, 57 Tax Notes 1567 (Dec. 14, 1992); Taylor, *Final Regulations Change Dual Consolidated Loss Rules*, 5 Tax Notes Int'l 723 (Oct. 5, 1992); Sparagna, *The Final Dual Consolidated Loss Regulations—An Overview and Comparison with the Temporary Regulations*, 21 Tax Mgmt. Int'l 671 (1992); Richard Skillman, Letter to Ms. Carol Doran-Klein, Acting Deputy International Tax Counsel (Dec. 11, 1992), *reprinted in* 93 TNT 39-36 (LEXIS, Fedtax Library, TNT File); Blessing, *Dual Consolidated Losses*, 99 Tax Notes 1215 (May 26, 2003); Hardy, *A Company Without a Country: The Dual Consolidated Loss Regime*, ***84 Tax Notes 747*** (Aug. 2, 1999).

Note that there can be interactions with other consolidated return rules. As one example, rather than isolating deductions in a DRC, consider a DRC group member that generates intercompany interest income from lending funds to another group member that is not a DRC, and whether the DRC should be permitted to offset any of its dual consolidated loss from other sources, or should its income be

[b] 1992 Regulations

Temporary regulations were issued under *IRC Section 1503(d)* in 1989 (the "temporary regulations").[64] Although the temporary regulations were finalized in 1992 (the "1992 regulations"), the temporary rules were retained as a separate regulation.[65] The temporary regulations remain effective for taxable years beginning after December 31, 1986 and before October 1, 1992, while the 1992 regulations generally apply for taxable years beginning on or after October 1, 1992.[66] While new final regulations were issued in 2007, the 1992 regulations remain effective for years prior to the effective date of the 2007 final regulations.[67] Therefore, the 1992 rules are still relevant.

Commentators generally criticized the temporary regulations as punitive.[68] For example, the temporary regulations required application of a stand-alone requirement to DRCs and was argued to be inconsistent with Congressional intent. Moreover, a SRLY limitation was argued to be appropriate only if a dual consolidated loss ("DCL") is actually used to offset income of another person for foreign tax purposes. Commentators also argued that the conditions for obtaining relief through an agreement were excessively burdensome.[69]

In response to the comments, the 1992 regulations more narrowly targeted application of the loss limitation rule. In particular, the stand-alone requirement was eliminated as a prerequisite for obtaining relief, with the regulations instead applying an actual use standard to DRCs. If a triggering event occurs, the DCL must be recaptured only in the year of the triggering event, subject to an interest charge, and amended returns need not be filed.

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recharacterized to prevent the offset (e.g., would permitting the offset effectively shift the offset DCL to the non-DRC member and outside the IRC Section 1503(d) limitations, and thereby undermine the IRC Section 1503(d))? *Cf.* PLR 199936045 (Sept. 29, 1998) (where *B* deducts intercompany royalty payments, Treas. Reg. § 1.1502-13(c)(4)(i)(A) requires the attributes of *S*'s offsetting royalty income to be redetermined to match the attributes of *B*'s deduction, and a portion of *S*'s royalty income therefore is treated as foreign trading gross receipts in order to achieve the overall effect of division-like treatment for *B* and *S* under the FSC rules); PLR 200048034 (Aug. 31, 2000) (where *B* includes its intercompany royalty payments in its cost of goods sold, and thus reduces its foreign taxable income for purposes of IRC Section 904(d) and computing the allowable FSC commissions, Treas. Reg. § 1.1502-13(c)(1) requires the attributes of the intercompany and corresponding items to be redetermined to achieve the overall effect of division-like treatment for *B* and *S* under the foreign tax credit and FSC rules without any specific guidance for whether it is *B*, *S*, or some combination, that must recharacterize its items). *See also* §§ 31.05[1][f] (matching rule international issues); 33.01[2][b] and [c] (other special rules for redetermining the attributes of items from intercompany loans). In the SRLY context, intercompany interest income of the SRLY member generally increases its SRLY register. *See* Treas. Reg. § 1.1502-13(c)(7)(ii), *Ex.* 10(d) (*S*'s intercompany item is not netted with *B*'s corresponding item in computing *S*'s SRLY limitation); *but see* Treas. Reg. § 1.1502-13(g)(7)(ii), *Ex.* 9 (excess intercompany interest income attributable to off-market terms recharacterized as a capital contribution).

64 ***TD 8261, 1989-2 CB 220***; INTL-399-88, 1989-2 CB 827.

65 ***TD 8434, 1992-2 CB 240***. Because the 1992 regulations redesignate Treas. Reg. § 1.1503-2T as Treas. Reg. § 1.1503-2A, citations to provisions under the temporary regulations are based on their current location under Treas. Reg. § 1.1503-2A.

66 The effective dates are set forth in Treas. Reg. § 1.1503-2(h).

67 ***TD 9315***, 72 FR 12902 (Mar. 16, 2007).

68 *See, e.g.,* American Bar Association, Section of Taxation, Committee on Affiliated and Related Corporations, *Comments Regarding Proposed and Temporary Regulations § 1.1503-2T* (Aug. 3, 1990), *reprinted in* 90 TNT 182-38 (LEXIS, Fedtax Library, TNT File); American Bar Association, Section of Taxation, Committee on Foreign Activities of U.S. Taxpayers, *Comments Regarding Proposed and Temporary Regulations § 1.1503-2T* (Dec. 10, 1991), *reprinted in* 92 TNT 7-67 (LEXIS, Fedtax Library, TNT File); American Institute of Certified Public Accountants, *Comments Regarding Temp. Treas. Reg. § 1.1503-2T Relating to the Dual Consolidated Loss Provisions Under IRC Section 1503(d) of the Internal Revenue Code of 1986* (June 26, 1992), *reprinted in* 92 TNT 139-27 (LEXIS, Fedtax Library, TNT File); Willard Taylor & John Vlahoplus, Letter to Commissioner of Internal Revenue (Nov. 7, 1989), *reprinted in* 89 TNT 231-40 (LEXIS, Fedtax Library, TNT File); ARCO, Letter to Commissioner of Internal Revenue Service (Nov. 7, 1989), *reprinted in* 89 TNT 231-41 (LEXIS, Fedtax Library, TNT File); AMOCO, Letter to the Internal Revenue Service (Feb. 13, 1990), *reprinted in* 90 TNT 42-34 (LEXIS, Fedtax Library, TNT File); Harvey Mogenson, Letter to the Internal Revenue Service (Feb. 16, 1990), *reprinted in* 90 TNT 42-36 (LEXIS, Fedtax Library, TNT File).

69 The requirements that the statute of limitations be waived for the carryforward period, and that taxpayers amend their returns if a triggering event occurs, were seen as impractical.

[i] Limitation on a DCL Offsetting Domestic Affiliate Income

The 1992 regulations retain the general rule that a DCL of a DRC cannot offset the income of any domestic affiliate.[70] A DCL is the NOL of a domestic corporation incurred in a year that the corporation is a DRC.[71] A DRC is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis.[72] The DCL provisions also continue to apply to the losses of a separate unit of a domestic

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70 Treas. Reg. § 1503-2(b)(1). While the statute prohibits the use of the loss against the income of any other member of the *affiliated group*, the regulations override the definition of this term in IRC Section 1504(a)(1) by providing that the loss cannot be used against the income of any *domestic affiliate.* Treas. Reg. § 1.1503-2(b)(1). This term is defined by ignoring all of the exceptions to includible corporation status in IRC Section 1504(b), except the exclusion of foreign corporations under IRC Section 1504(b)(3). Treas. Reg. § 1.1503-2(c)(13). Consequently, while the statute would not bar the use of a noninsurance subsidiary's loss by a life company as the result of a IRC Section 381 transaction, the regulations prevent such a carryover. (Strangely, an *unaffiliated domestic corporation* is defined in Treas. Reg. § 1.1503-2(c)(14) as a domestic corporation not included in an affiliated group, and because the IRC Section 1504(a) definition of an affiliated group is not modified by the regulations, it is possible for certain corporations such as a domestic life insurance company to be *both* a domestic affiliate and an unaffiliated domestic corporation.)

71 Treas. Reg. § 1.1503-2(c)(5). The fact that a particular item taken into account in computing a DRC's net operating loss is not taken into account in computing income subject to a foreign country's income tax does not permit the item to be excluded from the calculation of the corporation's DCL. Treas. Reg. § 1.1503-2(c)(5). Commentators suggested that the definition in the temporary regulations be amended to exclude any items that cannot be used to offset the income of a foreign person. The preamble to the 1992 regulations explains that this item-by-item analysis was rejected because of the administrative complexity, as well as the statutory language and legislative history which evidence an intention to disallow a DRC's entire net operating loss rather than specific components thereof. ***TD 8434, 1992-2 CB 240***. For the same reasons, the Service did not adopt the suggestion that the disallowance or recapture of a DCL be limited to the portion of the loss that is actually used to offset income of another person for foreign tax purposes.

A DCL does not include the NOL incurred during that portion of the taxable year before the date on which the corporation becomes a DRC, or after the date on which the corporation ceases to be a DRC. Treas. Reg. § 1.1503-2(c)(5)(ii)(B). The regulations provide a "cap" on the amount of the net operating loss deemed incurred in that portion of the taxable year before the date on which the domestic corporation becomes a DRC, or after the date on which the domestic corporation ceases to be a DRC. The cap is equal to the aggregate of the equal daily portion of the net operating loss commensurate with the portion of the taxable year during which the domestic corporation was not a DRC. Treas. Reg. § 1.1503-2(c)(5)(ii)(B).

In addition, the DCL of any DRC that ceases to be a DRC shall not be used to offset income of such corporation to the extent that such income is tainted income. Treas. Reg. § 1.1503-2(e)(1). Tainted income is any income derived from tainted assets, beginning on the date such assets are acquired by the DRC. Treas. Reg. § 1.1503-2(e)(2). Tainted assets are any assets acquired by a DRC in a nonrecognition transaction, as defined in IRC Section 7701(a)(45), or any assets otherwise transferred to the corporation as a contribution to capital, at any time during the three taxable years immediately preceding the taxable year in which the corporation ceases to be a DRC or at any time thereafter (but after December 31, 1986). Treas. Reg. § 1.1503-2(e)(3). There are exceptions to the definition of a tainted asset to cover assets contributed after the corporation ceases to be a DRC, as well as assets contributed prior to such date. The exceptions to the definition of a tainted asset in the 1992 regulations were expanded beyond the temporary regulations to include (i) assets contributed in a year in which the corporation did not incur a DCL (or have a carryover of a DCL) and (ii) assets acquired as replacement property in the ordinary course of business. The 1992 regulations also contain a rule for determining the amount of income attributable to tainted assets. Treas. Reg. § 1.1503-2(e)(4).

It also does not include losses incurred in taxable years beginning on or before December 31, 1986. Treas. Reg. § 1.1503-2A(b)(2)(ii).

72 Treas. Reg. § 1.1503-2(c)(2). The definition of DRC was modified in the 1992 regulations to more closely conform to the language of the statute. IRC Section 1503(d)(2)(A). An S corporation as defined under IRC Section 1361 is not a DRC. Treas. Reg. § 1.1503-2(c)(2). For purposes of determining whether a domestic corporation is subject to the income tax of a foreign country on its income, the fact that the corporation has no actual income tax liability to the foreign country for a particular taxable year is not considered. Treas. Reg. § 1.1503-2(c)(6).

A *domestic corporation* is defined in IRC Section 7701(a)(3) and (4) and includes any corporation treated as a domestic corporation under the Code, including, but not limited to, IRC Sections 269B, 953(d) and 1504(d). Treas. Reg. § 1.1503-2(c)(1). IRC Section 1503(d) literally applies to foreign corporations that are treated as domestic corporations pursuant to an election under IRC Section 1504(d).

corporation as if this unit were a wholly owned subsidiary of the domestic corporation.[73] In essence, separate units are treated as separate DRCs.[74]

Unless a specific regulatory exception applies, the prohibition on the use of losses applies regardless of whether the loss offsets the income of another person under the income tax laws of a foreign country and regardless of whether the income that the loss might otherwise offset in the foreign country is subject to tax in the United States.[75]

When Congress enacted IRC Section 1503(d) in 1986, there was no indication in the statute or the legislative history that the benefit given to a contiguous country corporation (a Mexican or Canadian wholly owned corporation that is maintained under either Mexican or Canadian law for the purpose of complying with such law as to title or operation of property) electing to be treated as a domestic corporation for the purpose of offsetting its losses against profits of other members of a consolidated group was to be abridged in any manner. Accordingly, if there exists no Mexican or Canadian corporation against which these foreign losses can be offset, there is no reason why a single corporation should be required to enter into the onerous certification requirements contained in the regulations.

The preamble to the 1992 regulations notes that many commentators have criticized the application of the DCL regulations to IRC Section 1504(d) corporations, stating that the statute was not intended to apply to such corporations. ***TD 8434, 1992-2 CB 240***. *See, e.g.*, AMOCO, *Letter to Steven R. Lainoff, Associate Chief Counsel (International) and Philip D. Morrison, International Tax Counsel* (Nov. 17, 1989), *reprinted in* ***89 TNT 251-32*** (LEXIS, Fedtax Library, TNT File). The 1992 regulations, however, continue to treat IRC Section 1504(d) corporations as DRCs because the language of the statute and legislative history does not support excluding such corporations. In effect, the Service is concerned that if, under the laws of a foreign country (e.g., Mexico or Canada), a IRC Section 1504(d) corporation's unused losses possibly could be acquired and used by another foreign corporation via a merger or some other tax-attribute transfer, the purpose of IRC Section 1503(d) might be circumvented. IRC Section 1504(d) was enacted in 1928 to overcome the fact that Mexico and Canada required certain businesses to be incorporated and maintained under their laws. If it were not for these provisions of foreign law, these companies could operate as a Canadian or Mexican branch of a domestic corporation. Absent further guidance, it seems to be outside the scope of the legislation's intent to prevent IRC Section 1504(d) corporations who are not in fact offsetting their losses in the foreign country from obtaining the unencumbered benefit of IRC Section 1504(d). For further discussion of IRC Section 1504(d), *see* § 11.02[4] (foreign corporations).

[73] IRC Section 1503(d)(3), added by ***P.L. 100-647***, § 1012(u) (1988). This Section was enacted to avoid the circumvention of the DCL rules by the use of partnerships or branches. A separate unit means (i) a foreign branch as defined in Treas. Reg. § 1.367(a)-6T(g); (ii) a partnership interest; or (iii) a trust interest. Treas. Reg. § 1.1503-2(c)(3)(i). A separate unit includes an interest in an entity that for U.S. tax purposes is not taxable as an association, but is subject to income tax in a foreign jurisdiction as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis. Treas. Reg. § 1.1503-2(c)(4). *See* FSA 200221018 (Feb. 13, 2002) (confirming that the Service will review all "facts and circumstances" to determine whether foreign activities constitute a "separate unit"). Separate units are also required to file annual certifications and waivers, although annual certifications are not required unless the separate unit is a hybrid entity separate unit (defined in Treas. Reg. § 1.1503-2(c)(4)). Treas. Reg. § 1.1503-2(g)(2)(vi)(C).

[74] Treas. Reg. § 1.1503-2(c)(2). *See, e.g.*, FSA 200101007 (Sept. 28, 2000) (foreign trusts constituted "separate units" even though the trusts did not constitute "permanent establishments" and, as such, had no tax filing obligations in the foreign jurisdiction, interests in foreign partnerships constituted "separate units" even though the foreign partnerships were not able to file consolidated returns under foreign law).

[75] Treas. Reg. § 1.1503-2(b)(1). Moreover, the 1992 regulations provide that a DCL of a DRC cannot be used to offset the income of another corporation by means of a transaction in which the other corporation succeeds to the tax attributes of the DRC under IRC Section 381 of the Code. Treas. Reg. § 1.1503-2(b)(2). *See also* ***PLR 9239031 (June 30, 1992)*** (the Service ruled that a DRC that transferred its assets to a foreign holding company in an "F" reorganization was unable to use its DCL to offset the income of another corporation (including the foreign holding company) under former Treas. Reg. § 1.1503-2T(a)). However, in contrast to the temporary regulations, the 1992 regulations provide that, if a DRC transfers its assets to another corporation in a transaction subject to IRC Section 381, and the acquiring corporation is a DRC of the same foreign country of which the transferor DRC is a resident or a domestic corporation that carries on the business activities of the transferor DRC as a separate unit, income generated by the transferee DRC, or separate unit, may be offset by the carryover losses of the transferor DRC. Treas. Reg. § 1.1503-2(b)(2). In addition, if a domestic corporation transfers a separate unit to another domestic corporation in a transaction subject to IRC Section 381, the income generated by the separate unit following the transfer may be offset by the carryover losses of the separate unit. Treas. Reg. § 1.1503-2(b)(2).

The regulations indicate that similar rules also apply to preclude the use of a DCL of a separate unit by a domestic corporation upon or as a result of the termination, liquidation, or sale of this separate unit. Treas. Reg. § 1.1503-2(b)(2). IRC Section 1503(d)(4), added by

[ii] Exceptions to the DCL Rules

There are three exceptions to the application of the DCL rules. The DCL rules will not apply if: (i) there is no ability to use the loss under foreign law; (ii) there is an agreement in place between the U.S. and the foreign country; or (iii) the taxpayer "certifies the loss."

Regarding the first exception, the DCL rules will generally *not* apply if there is no ability to use the DCL under foreign law.[76] Specifically, the regulations provide that an NOL sustained by a DRC is not treated as a DCL in the following circumstances:

(1) the income tax laws of a foreign country do not permit the DRC 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; and

(2) under the income tax laws of a foreign country, the losses, expenses, or deductions of the DRC cannot be carried over or back to be used, by any means, to offset the income of any other person in other taxable years.[77]

For purposes of this exception to the DCL rules, the following provisions are applicable:

(1) A DCL is deemed to offset income of a domestic affiliate in the year it is included in the computation of the consolidated taxable income of a consolidated group. The fact that no tax benefit results from the inclusion of the DCL in the computation of the group's consolidated taxable income in the taxable year is not taken into account.

(2) Except as provided in (3), below, an item taken into account in computing a DCL is deemed to offset income of another person under the income tax laws of a foreign country in the year it is made available

P.L. 100-647, § 1012(u) (1988), also prohibits the use of a DCL by contributing assets to a corporation that otherwise cannot use this loss to shelter the income generated by those assets.

Example: *Successor.* (a) *P*, a domestic corporation, owns all of the outstanding stock of *DRC*, a domestic corporation. *P* and *DRC* file a consolidated U.S. income tax return. *DRC* is managed and controlled in Country *W*, a country that determines the tax residence of corporations according to their place of management and control. Therefore, *DRC* is a dual resident corporation and any net operating loss it incurs is a DCL. In Years 1 through 3, *DRC* incurs DCLs. The DCLs may not be used to offset *P*'s income on the group's consolidated U.S. income tax return. At the end of Year 3, *DRC* sells all of its assets and discontinues its business operations. *DRC* is then liquidated into *P*, pursuant to the provisions of IRC Section 332. Normally, under IRC Section 381, *P* would succeed to and be permitted to utilize *DRC*'s net operating loss carryovers. However, the DCL rules prohibit the DCLs of *DRC* from reducing *P*'s income for U.S. tax purposes. Therefore, *DRC*'s net operating loss carryovers will not be available to offset *P*'s income unless one of the exceptions discussed below applies.

(b) The facts are the same, except that *DRC* does not sell its assets and, following the liquidation of *DRC*, *P* continues to operate *DRC*'s business as a separate unit (*e.g.*, a branch). *DRC*'s loss carryovers are available to offset *P*'s income generated by the assets previously owned by *DRC* and now held by the separate unit.

Treas. Reg. § 1.1502-2(b)(4), *Ex.*

[76] IRC Section 1503(d)(2)(B).

[77] Treas. Reg. § 1.1503-2(c)(5)(ii)(A). Practically, it is very difficult to get an opinion from foreign counsel that a loss can "never" be used by another person. The regulations are written so broadly that they potentially encompass situations in which another person is allowed to use a deduction by virtue of a step up in basis. *See* FSA 200221018 (Feb. 13, 2002) (confirming that a taxpayer carries a heavy burden of proof when attempting to prove a "negative," i.e., that a loss can never be used to offset the income of another person).

for this offset. The fact that the other person does not have sufficient income in that year to benefit from such an offset is not taken into account. But if the laws of a foreign country provide an election that would enable a DRC or separate unit to use its item to offset income of another person, then it is considered to offset that income only if the election is made.

(3) Items taken into account in computing a DRC's DCL will not be deemed to offset income of another person under the income tax laws of a foreign country, if under the laws of the foreign country the item is used to offset the income of another DRC within the same consolidated group. If the item of a DRC is made available under the laws of a foreign country to offset the income of other DRCs within the same consolidated group, as well as the income of another person, and the laws of the foreign country do not provide applicable rules for determining which person's income is offset by the item, it is deemed to offset the income of the other DRCs to the extent of that income, before being considered to offset the income of the other person.

(4) If the income tax laws of a foreign country deny the use of an item of a DRC to offset the income of another person because the DRC is also subject to income taxation by another country on its worldwide income or on a residence basis, the DRC will be treated as if it actually had offset its DCL against the income of another person in that foreign country.[78]

Example:

Treatment of a branch as a subsidiary. X, a member of a consolidated group, conducts business through a branch in Country *Y*. Under Country *Y*'s income tax laws, the branch is taxed as a permanent establishment and its losses can be used under the Country *Y* form of consolidation to offset the income of *Z*, a Country *Y* affiliate of *X*. In Year 1, the branch of *X* incurs an overall loss that

[78] Treas. Reg. § 1.1503-2(c)(15). This so-called "mirror legislation" rule was aimed at legislation in the United Kingdom. Effective April 1, 2000, the U.K. extended its group relief provisions (including its mirror legislation) to losses arising in a U.K. branch of a non-U.K. corporation. As a result, a U.S. corporation may be precluded from certifying the losses incurred by a U.K. branch. The restriction does not apply, however, to losses of a "hybrid branch" (a U.K. company that elected to be treated as a branch for U.S. tax purposes). *See also* Margaret O'Connor, Letter to John Staples, Associate Chief Counsel (International) (Feb. 12, 2002), *reprinted in* 2002 TNT 40-36 (LEXIS, Fedtax Library, TNT File)(discussing the implications of the German mirror legislation).

The "mirror legislation" rule prohibits a DRC from using the stand-alone exception if no other entity can use the loss because "the income tax laws of the foreign country deny the use of losses, expenses, or deductions" of the dual resident. In other words, the "mirror legislation" rule maintains the general prohibition against the use of DCLs by domestic affiliates if the foreign country has enacted legislation "mirroring" IRC Section 1503(d). The "mirror legislation" rule protects the viability of IRC Section 1503(d) because it prevents the U.S. from losing money to foreign tax jurisdictions whenever the foreign jurisdiction passes its own legislation prohibiting the use of DCLs.

The rule in Treas. Reg. § 1.1503-2(c)(15) is substantially the same as the prior rule in Treas. Reg. § 1.1503-2A(c)(1)(ii)(B), which applies for taxable years beginning after December 31, 1986 and before October 1, 1992, and was considered in *British Car Auctions, Inc. v. U.S.*, 35 Fed. Cl. 123 (Fed. Cl. 1996), aff'd per curiam, ***116 F.3d 1497 (Fed. Cir. 1997)***. The "mirror legislation" rule of Treas. Reg. § 1.1503-2A(c)(1)(ii)(B) was upheld as a reasonable interpretation of IRC Section 1503(d), and the disallowance of a DRC's attempt to offset losses against its affiliates' income was sustained. British Car Auctions, Inc. and its subsidiary, Auto Auctions, Inc., were DRCs of the U.S. and the U.K. British Car and its affiliates incurred NOLs that they sought to carry back to 1987 and apply against the income of the larger consolidated group of which British Car and Auto Auctions were a part. The Service applied the mirror legislation rule to the U.K. legislation that barred use of the losses to reduce affiliates' income there, concluded that the taxpayer did not come within the stand-alone provision, and disallowed the refund claim. The court emphasized the deference owed to agency interpretations of congressional mandates, stating that "Congress did not intend a blanket exception to the general rule whenever a foreign corporation was not capable of using the DRC's losses under foreign tax laws." While the Service's "mirror legislation" rule does not allow use of DCLs even when foreign law precludes a foreign affiliate from using the DRC's losses, the court concluded that IRC Section 1503(d) allows for this. The government conceded that British Car and each affiliate should be permitted to carry back their respective losses to offset their own income for 1987, because IRC Section 1503(d) relates only to the use of a DRC's losses by an affiliate.

would be treated as an NOL if the branch were a separate domestic corporation. The branch of *X* is treated as a separate domestic corporation and a DRC. Thus, its loss constitutes a DCL. Unless *X* qualifies for an exception under *Treas. Reg. § 1.1503-2(g)*, *IRC Section 1503(d)* precludes the use of the branch's loss to offset any income of *X* not derived from the branch operations or any income of a domestic affiliate of *X*.[79]

Example:

Treatment of partnership as a subsidiary. A and *B* are members of a consolidated group. *FC* is a Country *X* corporation that is wholly owned by *B*. *A* and *B* organize a partnership, *P*, under the laws of Country *X*. *P* conducts business in Country *X* and its business activity constitutes a foreign branch. *P* also earns U.S. source income that is unconnected with the branch operations and, therefore, is not subject to tax by Country *X*. Under the laws of Country *X*, the branch can consolidate with *FC*. The interests in *P* held by *A* and *B* are each treated as a DRC. The branch is also treated as a separate DRC. Unless an exception under *Treas. Reg. § 1.1503-2(g)* applies, any DCL incurred by *P*'s branch cannot offset the U.S. source income earned by *P* or any other income of *A* or *B*.[80]

Example:

Stacking loss first against another member of the consolidated group. P, a domestic corporation, files a consolidated U.S. income tax return with its two wholly owned domestic subsidiaries, *DRC1* and *DRC2*. Each subsidiary is also treated as a Country *Y* resident for Country *Y* tax purposes. Thus, *DRC1* and *DRC2* are dual resident corporations. *DRC1* owns *FC*, a Country *Y* corporation. Country *Y*'s tax laws permit affiliated resident corporations to file a form of consolidated return. In Year 1, *DRC1* incurs a $200 NOL for both U.S. and Country *Y* tax purposes, while DRC2 recognizes $200 of income under the tax laws of each country. *FC* also earns $200 of income for Country *Y* tax purposes. *DRC1*, *DRC2*, and *FC* file a Country *Y* consolidated return. However, Country *Y* has no applicable rules for determining which income is offset by *DRC1*'s $200 loss. Accordingly, *DRC1*'s loss is treated as offsetting *DRC2*'s $200 of income. Because *DRC1* and *DRC2* are members of the same consolidated group, the offset of *DRC1*'s loss against the income of *DRC2* is not considered a use of the loss against the income of another person under the laws of a foreign country.[81]

Example:

Mirror legislation. DRC, a domestic corporation, files a consolidated U.S. income tax return with its parent, *P*. *DRC* is also subject to tax in Country *Y* on its worldwide income. Therefore, *DRC* is a dual resident corporation and any NOL incurred by *DRC* is a DCL. Country *Y*'s tax laws permit

79 Treas. Reg. § 1.1503-2(c)(16), *Ex. 1*.

80 Treas. Reg. § 1.1503-2(c)(16), *Ex. 2*.

81 Treas. Reg. § 1.1503-2(c)(16), *Ex. 4*.

corporations that are subject to tax on their worldwide income to use the Country *Y* form of consolidation, thus enabling eligible corporations to use their losses to offset income of affiliates. However, to prevent corporations like *DRC* from offsetting losses against income of affiliates in Country *Y* and then again offsetting against income of foreign affiliates under the tax laws of another country, Country *Y* prevents a corporation that is also subject to the income tax of another country on its worldwide income or on a residence basis from using the Country *Y* form of consolidation. Because of Country *Y*'s statute, *DRC* will be treated as having actually offset its losses against the income of affiliates in Country *Y* under "(4)," above. Accordingly, *DRC* will not be able to file a Treas. Reg. § 1.1503-2(g)(2) agreement and will not be permitted to offset its losses against the income of *P* or any other domestic affiliate.[82]

The second exception to the application of the DCL rules applies when there is an agreement between the U.S. and the foreign country. Specifically, the regulations provide that the DCL provisions do not apply to the extent that the loss is subject to an election by the DRC to deduct the loss in the U.S. pursuant to an agreement entered into between the U.S. and the foreign country that puts into place an elective procedure through which losses would offset income in only one country.[83]

The third exception to the application of the DCL rules applies if the DRC enters into an agreement under which it certifies annually that the DCL has not been, and will not be, used to offset the income of another person under the laws of a foreign country.[84] Under this exception, a DCL will be currently allowed in the U.S. if the DRC (i) certifies that no foreign benefit has been or will be taken for the losses, and (ii) agrees to recapture and report as income the amount of the DCL and to pay an applicable interest charge as determined after the occurrence of a so-called triggering event, discussed below.[85] The annual certification must be made for each of the subsequent years that the DCL was not used to offset income of another person under the tax laws of the foreign country for the 15-year period following the year in which the DCL arose.[86]

[iii] Triggering Events Recapturing a DCL

The primary triggering event causing recapture under the regulations is the use of any portion of the losses, expenses, or deductions that make up the DCL to offset the income of another person under the laws of a foreign country in any taxable year up to and including the 15th taxable year following the year in which

82 Treas. Reg. § 1.1503-2(c)(16), *Ex. 5.*

83 Treas. Reg. § 1.1503-2(g)(1). The U.S. has not entered into any such agreements.

84 Treas. Reg. § 1.1503-2T(g)(2)(i). The agreement must be attached to the group's timely filed U.S. income tax return for the taxable year in which the DCL is incurred. There are numerous instances in which the Service has granted an extension of time under Treas. Reg. § 301.9100 with respect to the certification required under Treas. Reg. § 1.1503-2A(d)(3) (former Treas. Reg. § 1.1503-2T(d)(3)) or the agreement required by Treas. Reg. § 1.1503-2(g)(2)(i).

The regulations also contain a consistency rule in the case of multiple DCLs arising in the same year. Under the consistency rule, if a DCL of a DRC is used under the laws of a foreign country to offset the income of another person, DCLs of other DRCs that are recognized in the same taxable year within the same consolidated group are also deemed to offset the income of another person with respect to that foreign country. Treas. Reg. § 1.1503-2(g)(2)(ii).

85 Treas. Reg. § 1.1503-2(g)(2)(iii)(A). Contrary to the temporary regulations previously in effect, a taxpayer is not required to amend its income tax return for the year in which the DCL was incurred. Instead, the 1992 regulations impose an interest charge that is intended to put taxpayers in approximately the same position that they would have been in as if an amended return had been filed upon a triggering event. *See* Treas. Reg. § 1.1503-2(g)(2)(vii)(A)(2).

86 Treas. Reg. § 1.1503-2T(g)(2)(vi)(B).

the DCL was incurred.[87] Additional triggering events are deemed to occur when (i) an affiliated DRC or affiliated domestic owner ceases to be a member of the consolidated group that filed the agreement at a time when there is a continuing ability to use the DCL to offset the income of another person for foreign tax purposes,[88] (ii) an unaffiliated DRC or unaffiliated domestic owner becomes a member of a consolidated group,[89] (iii) a DRC or a domestic owner of a separate unit transfers 50% or more of its assets in a transaction that results, under the laws of a foreign country, in a carryover of the losses, expenses, or deductions that make up the DCL to the transferee of the assets,[90] (iv) a domestic owner of a separate unit disposes of 50 percent or more of its interest in the separate unit at a time when there is a continuing ability to use the DCL to offset income of another person for foreign tax purposes,[91] (v) an unaffiliated DRC or unaffiliated domestic owner becomes a foreign corporation in a transaction that, for foreign tax purposes, is not treated as involving a transfer of assets to a new entity,[92] or (vi) the consolidated group fails to file the annual certification.[93]

The 1992 regulations generally provide that a triggering event does not occur, provided the taxpayer enters into a closing agreement, when a DRC or a domestic owner of a separate unit become disaffiliated from its consolidated group, or when an unaffiliated domestic corporation or new consolidated group acquires the DRC, the separate unit, or their assets.[94]

[iv] Special Accounting Rules for DCLs

For purposes of determining whether a DRC that is a member of an affiliated group filing a consolidated return has a DCL for the taxable year, the DRC must compute its taxable income (or loss) in accordance with the regulations under *IRC Section 1502* for the computation of consolidated taxable income, taking into

87 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(1).

88 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2). A DRC will be deemed to have ceased to be a member of the affiliated group that filed the agreement if it is no longer a member of that group (as defined in Treas. Reg. § 1.1502-1(b), or if the group ceases to exist because the common parent is no longer in existence or is no longer the common parent or the group no longer files a consolidated return. Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(2). The DRC does not cease to be a member solely by reason of an acquisition of its assets by a member in a transaction to which IRC Section 381(a) applies, provided the successor corporation continues to be a member of the group or the assets of an affiliated DRC are acquired by a member of its consolidated group in any other transaction. Treas. Reg. § 1.1503-2(g)(2)(iv)(A). It was anticipated that questions pertaining to DCLs will be added to Form 1120 (or the Schedules thereto). In general, these questions will monitor the occurrence of triggering events. Until these questions are added to the income tax return, DRCs and domestic owners of hybrid entity separate units will be required to file annual certifications, in accordance with the provisions of Treas. Reg. § 1.1503-2T(g)(2)(vi)(B), for the 15-year period following the year in which the DCL has been incurred. The annual certification must warrant that the DCL has not been used to offset the income of another person under foreign law. Treas. Reg. § 1.1503-2T(g)(2)(vi)(B). Owners of separate units other than hybrid entities will not be required to file such annual certifications but must answer the applicable questions on Form 1120. Treas. Reg. § 1.1503-2(g)(2)(vi)(C).

89 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(3). If the consolidated group files an agreement under Treas. Reg. § 1.1503-2T(g)(2)(i), with its timely filed income tax return for the taxable year in which the event occurs, a triggering event will not occur. Treas. Reg. § 1.1503-2T(g)(2)(iv)(B)(3)(iii).

90 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(4) and (5).

91 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(7).

92 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(6).

93 Treas. Reg. § 1.1503-2(g)(2)(iii)(A)(8).

94 Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(1). A closing agreement is not required when a DRC, or domestic owner, that is a member of a consolidated group becomes a member of another consolidated group in an acquisition, so long as each member of the acquired group that is an includible corporation under IRC Section 1504(b) is included immediately after the acquisition in a consolidated U.S. income tax return filed by the acquiring group. Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(2)(ii). *See also* Rev Proc 2000-42, 2000-2 CB 394 (guidelines for closing agreement requests); Rev Proc 2001-22, 2001-1 CB 745 (announcing a pre-filing program for the recapture of DCLs).

account only the DRC's items of income, gain, deduction, and loss other than any net capital loss incurred by the DRC, or any carryover or carryback losses.[95] Unlike the temporary regulations, deferral provisions, such as *Treas. Reg. § 1.1502-13* and *IRC Section 267(f)*, are taken into account under the 1992 regulations.[96] Commentators criticized the investment adjustment rules of the temporary regulations, arguing that requiring a negative adjustment for recognized but unabsorbed DCLs results in a double penalty to the taxpayer and is contrary to the principles of *Treas. Reg. § 1.1502-32*. The 1992 regulations, however, retain the negative basis adjustment requirement because the application of *Treas. Reg. § 1.1502-32*, without modification, could result in an indirect deduction of a DCL.[97]

Example:

Consolidated computation results in DCL. (a) *P*, *S1*, *S2*, and *T* are domestic corporations. *P* owns all of the stock of *S1* and *S2*. *S2* owns all of the stock of *T*. *T* is a resident of Country FC for Country FC income tax purposes, and therefore a dual resident corporation. *P*, *S1*, *S2*, and *T* file a consolidated U.S. income tax return. *X* and *Y* are corporations that are not members of the consolidated group. At the beginning of Year 1, *P* has a $100 basis in the stock of *S2*, and *S2* has a $50 basis in the stock of *T*. In Year 1, *T* incurs $10 of interest expense. In addition, *T* sells noncapital asset u, in which it has a $1 basis, to *S1* for $5. *T* also sells noncapital asset v, in which it has a $20 basis, to *S1* for $10. The sales of u and v are intercompany transactions described in *Treas. Reg. § 1.1502-13(b)(1)*. *T* also sells capital asset z, in which it has an $18 basis, to *Y* for $9. In Year 1, *S1* earns $20 of separate taxable income, calculated in accordance with *Treas. Reg. § 1.1502-12*, as well as $9 of capital gain from a sale of an asset to *X*. *P* and *S2* have no items of income, loss, or deduction for Year 1.[98]

(b) In Year 1, *T* has a DCL of $10 (attributable to its interest expense). *T*'s $9 capital loss is not included in the computation of the DCL. Instead, *T*'s capital loss is included in the computation of the

[95] Treas. Reg. § 1.1503-2(d)(1)(i). Commentators noted that the calculation of a DCL under the temporary regulations could result in the inclusion of a DRC's capital losses as part of its DCL, which is inconsistent with legislative intent. Such a result is unintended. Therefore, the 1992 regulations provide that a DCL shall be computed by taking into account a DRC's items of income, gain, loss, and deduction for the taxable year, other than any net capital loss incurred by the DRC, or any carryover or carryback losses. If the DRC has a net capital loss for the year, the loss is not treated as a DCL, and is instead included in the computation of the consolidated group's capital gain (or loss). *See, e.g.,* PLR 199906016 (Nov. 9, 1998).

The 1992 regulations clarify that, if the loss limitation rule applies to a DCL of a DRC or separate unit, the loss is disregarded for purposes of computing the consolidated group's or unaffiliated domestic owner's foreign tax credit limitation. The DCL is taken into account for foreign tax credit limitation purposes in the year that it is absorbed. Treas. Reg. § 1.1503-2(d)(2) and (f).

[96] Commentators noted that the nonapplication of the deferral or elimination rules of Treas. Reg. § 1.1502-13(b)(2) or (c) and Treas. Reg. § 1.1502-14 under the temporary regulations resulted in a mismatching of intercompany items. *See, e.g.,* ARCO, Letter to Commissioner of Internal Revenue Service (Nov. 7, 1989), 89 TNT 231-41 (LEXIS, Fedtax Library, TNT File). Addressing these concerns, the 1992 regulations do not override the application of these provisions, or the provisions of IRC Sections 267 and 163(e)(3). Thus, a sale of property at a gain by a DRC to another member of the consolidated group would not reduce a DCL because the gain on sale is deferred. Likewise, a sale of property to a related party at a loss that is disallowed under IRC Section 267(a) does not increase a DCL.

[97] Treas. Reg. § 1.1503-2(d)(3)(i)(B); ***TD 8434, 1992-2 CB 240***. These regulations were developed concurrently with the loss disallowance regulations under former Treas. Reg. § 1.1502-20 (2008), which have since been superseded by Treas. Reg. § 1.1502-36. For further discussion, *see* Chapters 72 (loss disallowance), 73 (loss duplication)) and 73A (unified loss rule). No preamble discussion in either regulation is directed at the interaction with the indirect loss concern under Treas. Reg. § 1.1503-2. Furthermore, nothing eliminates the perceived indirect benefit from a DCL for affiliates that do not file, or are not permitted to file, a consolidated return with the DRC. Thus, interposing a partnership or other unaffiliated entity as the shareholder of the DRC should allow the utilization of a loss from the disposition of DRC stock.

[98] Treas. Reg. § 1.1503-2(d)(4), *Ex. 1*.

consolidated group's capital gain net income under *Treas. Reg. § 1.1502-22* and is used to offset *S1*'s $9 capital gain. No elective agreement under *Treas. Reg. § 1.1503-2(g)(1)* exists between the U.S. and Country FC. For Country FC tax purposes, *T*'s $10 loss is offset against the income of a Country FC affiliate. Because *T* has a DCL for the year, the consolidated taxable income of the consolidated group is calculated without *T*'s items of income, loss or deduction taken into account in computing the DCL. Therefore, the consolidated taxable income of the consolidated group is $20 (the sum of $20 of separate taxable income earned by *S1* plus $9 of capital gain earned by *S1* minus $9 of capital loss incurred by *T*). The $4 gain recognized by *T* on the sale of item u to *S1* and the $10 loss recognized by *T* on the sale of item v to *S1* are deferred pursuant to *Treas. Reg. § 1.1502-13*.[99]

(c) *S2* must reduce it basis in the *T* stock under *Treas. Reg. § 1.1502-32* to reflect *T*'s $10 DCL even though the loss is not yet absorbed. In addition, *T*'s $9 capital loss is absorbed and also reflected as a negative investment adjustment. Thus, *S* reduces its basis from $50 to $31. Under *Treas. Reg. § 1.1502-33*, *S2*'s E&P for Year 1 reflects an allocable part of *T*'s E&P deficit. Because *S2* has no other E&P for the taxable year, *S2* has a $19 deficit in E&P for the year. Similarly, *P* must also make a negative adjustment to its basis in the stock of *S2*, and reduce its E&P, to reflect an allocable part of *T*'s loss and deficit in E&P for the taxable year. Thus, *P* must reduce its basis in the *S2* stock from $100 to $81, and reduce its E&P by $19.[100]

Example:

Consolidated computation results in no DCL. (a) The facts are the same as in the prior Example, except that in Year 2, *S1* sells u and v to *X* at no gain or loss. The disposition by *S1* of u and v restores *T*'s intercompany loss and gain. *T* also incurs $10 of interest expense in Year 2. In addition, *T* sells noncapital asset r, in which it has a $10 basis, to *Y* for $30. *P* and *S2* have no items of income, loss, or deduction for Year 2. *T* has no DCL for Year 2, based on the following computation:

($	10)	Interest expense
	(10)	Sale of v to *S1*
	4	Sale of u to *S1*
	20	Sale of r to *Y*
$	4	[101]

(b) Because *T* does not have a DCL for the taxable year, the group's consolidated taxable income is calculated in accordance with the general rule of *Treas. Reg. § 1.1502-11*, and not *Treas. Reg. § 1.1503-2(d)(2)*. *T* is the only member of the consolidated group that has any income or loss for the taxable year. Thus, the consolidated taxable income of the group, computed without regard to *T*'s DCL carryover, is $4.[102]

(c) Under *Treas. Reg. § 1.1502-21(c)*, the amount of the DCL arising in Year 1 that is included in the group's CNOL deduction for Year 2 is $4 (that is, the consolidated taxable income for Year 2 computed by taking into account only the items of *T*). Thus, the group has no consolidated taxable income for the year.

(d) Under *Treas. Reg. § 1.1502-32*, *S2* must adjust its basis in the *T* stock to reflect *T*'s income or loss. For this purpose, the $4 of *T*'s DCL of *T* carried over from Year 1 and absorbed in Year 2 was already treated as a negative adjustment in Year 1

99 Treas. Reg. § 1.1503-2(d)(4), *Ex. 1.*

100 Treas. Reg. § 1.1503-2(d)(4), *Ex. 1.*

101 Treas. Reg. § 1.1503-2(d)(4), *Ex. 2.*

102 Treas. Reg. § 1.1503-2(d)(4), *Ex. 2.*

and has no further effect in Year 2. Thus, *S2* increases its basis in the *T* stock from $31 to $35. Under *Treas. Reg. § 1.1502-33*, *S2*'s E&P for Year 2 increase by $4 to reflect *T*'s E&P for the year. Because it has no other sources, *S2* has $4 of E&P for the year. *P* must similarly increase its basis in the stock of *S2* from $81 to $85, and increase its E&P by $4.[103]

[v] Effective Dates

The 1992 regulations are effective for taxable years commencing on or after October 1, 1992, and ending before the effective date of the final regulations issued in 2007 as discussed below.[104] The temporary regulations were also finalized and apply to taxable years commencing after December 31, 1986, but before October 1, 1992.[105] But eligible taxpayers can elect to replace agreements or certifications filed under the temporary regulations with an agreement described in the 1992 regulations.[106] In addition, taxpayers that are in compliance with the temporary regulations but have not filed for relief thereunder can elect to apply the 1992 regulations retroactively to DCLs incurred in all open years.[107] If the taxpayer is a consolidated group, the election to replace existing agreements or certifications, or to otherwise apply the 1992 regulations retroactively, must be made with respect to all DRCs or separate units within the consolidated group.[108]

[c] 2007 Regulations

[i] Introduction

New *IRC Section 1503(d)* regulations were proposed in 2005 to address three fundamental concerns arising under the 1992 version of the Section 1503(d) regulations: (1) the potential over- and under-inclusiveness of the 1992 regulations; (2) various technical problems under the 1992 regulations, particularly after adoption of the entity classification regulations under *Treas. Reg. §§ 301.7701-1* through 301.7701-3; and (3) the administrative burdens of the 1992 regulations.[108.1]

Broadly speaking, the 2005 proposed regulations retained the overall operational approach of the 1992 regulations. For example, the proposed regulations prevent the DCL of a DRC or a separate unit generally from offsetting the income of a domestic affiliate. Exceptions to this limitation were provided if an election was filed (a "domestic use election"), if there was no possibility of a foreign use of the DCL ("no foreign use exception"), or if the U.S. had entered into an agreement with the foreign country to prevent the DCL's use in more than one country. If a domestic use election was filed (so the loss could offset income of a domestic affiliate), the occurrence of certain events ("triggering events") could cause the DCL to be recaptured. The proposed regulations also introduced the concept of a "foreign use" of a DCL that could prevent a domestic use election from being made, or could cause a triggering event requiring recapture of a previously certified DCL.

Final *IRC Section 1503(d)* regulations were issued in 2007 (the "2007 regulations" or "final regulations").[108.2] The 2007 regulations significantly modify certain aspects of the 2005 proposed regulations and add several new provisions. The 2007 regulations generally apply to DCLs incurred in taxable years beginning on or after April 18, 2007, but taxpayers can apply the 2007 regulations (in their entirety) to DCLs incurred in taxable years beginning on or after January 1, 2007. Thus, the 1992 regulations generally have continued vitality to DCLs incurred in prior taxable years.

[ii] Entities Subject to the DCL Rules

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103 Treas. Reg. § 1.1503-2(d)(4), *Ex. 2.*

104 Treas. Reg. § 1.1503-2(h)(1).

105 *See* Treas. Reg. § 1.1503-2A.

106 Treas. Reg. § 1.1503-2(h)(2)(ii). *See* Treas. Reg. § 1.1503-2(g)(2) (replacing Treas. Reg. § 1.1503-2A(c)(3) (agreements) and (d)(3) (certifications)).

107 Treas. Reg. § 1.1503-2(h)(3).

108 Likewise, if the taxpayer is an unaffiliated domestic owner, the election must be made with respect to all separate units of the domestic owner. Treas. Reg. § 1.1503-2(h)(3).

108.1 *See* REG-102144-04, 2005-25 CB 1297, corrected by Announcement 2005-56, 2005-2 CB 318.

108.2 *See* ***TD 9315, 2007-1 CB 891***, corrected by Announcement 2007-49, 2007-1 CB 1300. For more detailed background, *see, e.g.*, Jacobs, O'Connor, Rollinson, *Consolidated Returns: Final Regulations on Dual Consolidated Losses: A Practical Guide* (Parts I and II), 9-07 The Tax Adviser 526 (Sept. 2007), and 10-07 The Tax Adviser 606 (Oct. 2007).

The 2007 regulations apply to the DCLs of a DRC or a "separate unit" (defined below). A separate unit is no longer treated as a domestic corporation or DRC for all purposes of applying the DCL regulations. Under the 2007 regulations, DRCs and separate units are treated differently when appropriate, with separate units treated as domestic corporations for only limited purposes, and the operative rules have been modified in certain cases to take into account differences between DRCs and separate units.

DRCs. A DRC is a domestic corporation subject to a foreign country's income tax on either a worldwide or a residence basis.[108.3] A domestic corporation is a corporation, association, joint-stock company, or insurance company created or organized under the laws of the U.S. or any state therein.[108.4] In addition, a domestic corporation includes any entity treated as a domestic corporation by the Code, such as: (1) a stapled entity under *IRC Section 269B*; (2) a foreign insurance company electing under *IRC Section 953(d)* to be treated as a domestic corporation; (3) a subsidiary created under *IRC Section 1504(d)* to comply with foreign law; and (4) an expatriated entity under *IRC Section 7874*.[108.5] Solely for purposes of the DCL rules, a domestic corporation does not include a regulated investment company (RIC), a real estate investment trust (REIT), or an S corporation.[108.6] A U.S. possession corporation is also not considered a domestic corporation.[108.7]

Separate Units. A separate unit includes either of the following that is carried on or owned, directly or indirectly,[108.8] by a domestic corporation (including a DRC): (1) a foreign business operation that, if carried on by a U.S. person, would constitute a foreign branch as defined in Treas. Reg. § 1.367(a)-6T(g)(1) ("foreign branch separate unit"), or (2) an interest in a hybrid entity ("hybrid entity separate unit").[108.9] A hybrid entity is an entity that is not taxable as an association for U.S. tax purposes but is subject to a foreign country's income tax as a corporation (or otherwise at the entity level) on its worldwide income or on a residence basis.[108.10]

A business operation carried on by a domestic corporation that is not a DRC does not constitute a foreign branch separate unit, provided the business operation is: (1) not carried on indirectly through a hybrid entity or a transparent entity, and (2) conducted in a country with which the U.S. has entered into an income tax treaty and is not treated as a permanent establishment under the treaty, or is not otherwise subject to tax on a net basis under the treaty.[108.11] A foreign branch separate unit may be owned by a DRC, or through a hybrid entity (an interest in which is a separate unit), even if the foreign branch is located in the same foreign country that subjects the DRC or hybrid entity to tax on its worldwide income or on a residence basis.[108.12] But if a domestic corporation (or two or more domestic corporations that are members of the same consolidated group) has two or more separate units ("individual separate units") that are located or subject to income tax on their worldwide income or on a residence basis in the same foreign country, they are treated as one separate unit (a "combined separate unit").[108.13]

108.3 *See* Treas. Reg. § 1.1503(d)-1(b)(2)(i). A corporation is taxed on a residence basis if it is taxed as a resident under foreign laws. A DRC also includes a foreign insurance company that makes an election under IRC Section 953(d) to be treated as a domestic corporation and is treated as a member of an affiliated group, regardless of whether it is subject to a foreign income tax. *See* Treas.Reg. § 1.1503(d)-1(b)(2)(ii). *See also* IRC Section 953(d)(3) (losses of such companies are treated as DCLs regardless of whether they can be absorbed under foreign law).

108.4 *See* IRC Section 7701(a)(3) and (4).

108.5 *See* Treas. Reg. § 1.1503(d)-1(b)(1).

108.6 *Id.*

108.7 *See* Treas. Reg. § 1.1503(d)-1(b)(7).

108.8 Under the 2007 regulations, "indirect" ownership means ownership through a partnership, a disregarded entity, or a grantor trust, regardless of whether the entity is a U.S. person. *See* Treas. Reg. § 1.1503(d)-1(b)(19).

108.9 *See* Treas. Reg. § 1.1503(d)-1(b)(4)(i).

108.10 *See* Treas. Reg. § 1.1503(d)-1(b)(3).

108.11 *See* Treas. Reg. §§ 1.1503(d)-1(b)(4)(iii), 1.1503(d)-7(c), *Ex. 2*.

108.12 *See* Treas. Reg. § 1.1503(d)-1(b)(4)(iv).

108.13 *See* Treas. Reg. §§ 1.1503(d)-1(b)(4)(ii), 1.1503(d)-7(c), *Ex. 1*. Separate units of a DRC foreign insurance company are not combined with separate units of any other domestic corporation. *See* Treas. Reg. § 1.1503(d)-1(b)(4)(ii).

The combination rule does not apply to DRCs, but a foreign branch separate unit or hybrid entity separate unit held by a DRC can form part of a combined separate unit.[108.14] Similarly, a separate unit otherwise eligible to join a combined separate unit, but that is owned indirectly through a separate unit in a different foreign country, is combined. For example, assume *P*, the common parent of the *P* consolidated group, owns directly *DEX*, a hybrid entity separate unit located in Country X. In addition, *P* indirectly owns *FB1*, a foreign branch located in Country X, through *DRC*, a dual resident corporation and member of the *P* consolidated group, and *FB2*, a foreign branch located in Country X, through *DEY*, a hybrid entity separate unit located in Country Y. The combined separate unit of the *P* consolidated group includes *DEX*, *FB1*, and *FB2*.

The combination rule is not elective.[108.15] Generally, any individual separate unit within a combined separate unit loses its character as an individual separate unit when the separate unit combination rule applies.[108.16] As a result, in determining whether there is a triggering event as a result of the transfer of the assets of a combined separate unit, all of the assets of the combined separate unit are taken into account (rather than only the assets of an individual separate unit within the combined separate unit). To implement the expanded combination rule, the final regulations provide guidance for making necessary basis adjustments to the stock of the multiple domestic corporations within the consolidated group that own an interest in a combined separate unit, to reflect the items of income, gain, deduction or loss included in the calculation of the DCL of the combined separate unit. The members of a consolidated group owning stock in an affiliated domestic owner of the combined separate unit must adjust their basis in the stock of the domestic owner in accordance with *Treas. Reg. § 1.1502-32*.[108.17] Separate rules apply for purposes of an affiliated domestic owner's basis in a partnership.[108.18] Both sets of rules should apply by allocating a DCL subject to the domestic use limitation to an individual separate unit to the extent it contributed items to the DCL. In the event a domestic owner is required to recapture all or a portion of a DCL, the recapture amount is allocated to the affiliated domestic owner of the individual separate unit within the combined separate unit to the extent it contributed items giving rise to the recaptured DCL.

Transparent Entities. The final regulations modify the definition of a separate unit to exclude interests in non-hybrid entity partnerships or interests in non-hybrid entity grantor trusts.[108.19] Accordingly, entities treated as partnerships for both U.S. and a foreign tax purposes are not considered separate units, and interests in them are no longer subject to the DCL rules. But partners of a non-hybrid entity partnership and beneficiaries of a non-hybrid entity grantor trust might be subject to the DCL rules if these entities own a separate unit.[108.20]

A "transparent entity" is an entity owned, directly or indirectly, by a domestic corporation if the entity is not: (1) taxable as an association for U.S. federal tax purposes, (2) subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis, and (3) a pass-through entity under the laws of the applicable foreign country.[108.21] Examples of a transparent entity include a U.S. limited liability company that is treated as a partnership or disregarded entity for U.S. tax purposes, but is subject to taxation for foreign tax purposes, and a company organized in a tax haven that elects to be treated as a partnership or disregarded entity for U.S. tax purposes.

The final regulations do not treat transparent entities (or interests therein) as DRCs or separate units and, as a result, do not cause the entities (or interests therein) to be subject to the DCL rules. Instead, the preamble to the final regulations states that the rules

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108.14 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 1*.

108.15 By contrast, Prop. Reg. § 1.987-1(b)(2)(ii)(A) permits taxpayers to elect to combine their IRC Section 987 qualified business units with the same functional currency, which may cause additional burdens. *See* Lukacs, *Dual Consolidated Loss Regulations Bring the Rules Into the Check-the-Box Era at Last*, 108 J. Tax'n 228-29 (April 2008).

108.16 *See* ***TD 9315, 2007-1 CB 891***, corrected by Announcement 2007-49, 2007-1 CB 1300.

108.17 *See* Treas. Reg. § 1.1503(d)-5(g)(3).

108.18 *See* Treas. Reg. § 1.1503(d)-5(g)(2).

108.19 *See* Treas. Reg. § 1.1503(d)-1(b)(4)(i). *Cf.* former Treas. Reg. § 1.1503-2(c)(3)(i)(B) and (C) (1992). A "grantor trust" is a trust any portion of which is treated as being owned by the grantor or another person under Subpart E of Subchapter J of the Code. *See* Treas. Reg. § 1.1503(d)-1(b)(15).

108.20 *See* Treas. Reg. § 1.1503(d)-1(b)(4)(i) and (b)(19).

108.21 *See* Treas. Reg. § 1.1503(d)-1(b)(16)(i). For this purpose, the applicable foreign country is the foreign country in which the relevant foreign branch separate unit is located or the foreign country that subjects the relevant hybrid entity to tax either on its worldwide income or on a residence basis. *See* Treas. Reg. §§ 1.1503(d)-1(b)(16)(i)(C), 1.1503(d)-7, *Ex. 26*.

aim to appropriately take such entities (or interests therein) into account when applying the DCL rules to DRCs and separate units.[108.22] Not treating losses of a transparent entity as DCLs is consistent with policy rationale behind the DCL rules because losses of transparent entities do not offset any stream of income other than that of its U.S. owners in a way that reduces tax liability.

Domestic Reverse Hybrid Entities. A domestic reverse hybrid entity is a partnership or limited liability company that elects to be treated as a corporation for U.S. tax purposes, but is treated as a pass-through entity under foreign law. A domestic reverse hybrid entity is neither a DRC nor a separate unit and, therefore, is not subject to the DCL rules. The preamble to the final regulations states that the government continues to study these and similar structures.[108.23]

[iii] Determining the Amount of a DCL

DRC. In the case of a DRC, a DCL is generally defined as an NOL incurred in a year in which the corporation is a DRC.[108.24] An affiliated DRC determines the DCL in accordance with the computation of consolidated taxable income under *IRC Section 1502*. The following items are not considered in the calculation of the DCL of an unaffiliated or affiliated DRC: (1) carryover or carryback losses; (2) net capital loss; and (3) items of income, gain, deduction, and loss attributable to an interest in a transparent entity or a separate unit of the DRC.[108.25]

Separate Unit and Transparent Entity. A DCL of a separate unit is generally the net loss attributable to a separate unit.[108.26] A separate unit computes the DCL as if it was a U.S. corporation. Specifically, only those items of income, gain, deduction, and loss of the domestic owner that are attributable to the separate unit are taken into account.[108.27] A domestic owner's net capital losses and carryover or carryback losses are not taken into account.[108.28] The rules of *IRC Section 1502* apply in the case of an affiliated U.S. owner.[108.29] An item of income cannot be attributed to more than one transparent entity or separate unit, and the items of income, gain, deduction, and loss attributable to the transparent entity or separate unit cannot offset income, gain, deduction, or loss of another transparent entity or separate unit.[108.30]

Foreign Branch Separate Unit. The regulations provide specific rules for calculating the DCL of a foreign branch separate unit. The principles of *IRC Section 864(c)(2)*, *(c)(4)*, and *(c)(5)* (as set forth in *Treas. Reg. §§ 1.864-4(c)* and *1.864-5 through 1.864-7*) apply in calculating the loss or income attributable to a foreign branch separate unit, with certain exceptions.[108.31] These rules apply for computing income and deductions of a foreign corporation that are effectively connected to a U.S. trade or business of the foreign corporation. The rules of *Treas. Reg. § 1.882-5* apply, with modifications, for purposes of identifying the items of interest expense that should be taken into account in determining taxable income or loss of a foreign branch separate unit.[108.32] Income, gain, loss, deductions, assets, liabilities, and activities of the U.S. owner's interest in a hybrid entity or transparent entity are taken into account only if the hybrid entity or transparent entity owns, directly or indirectly (other than through a hybrid entity or transparent entity) a foreign branch separate unit.[108.33]

108.22 ***TD 9315, 2007-1 CB 891***, corrected by Announcement 2007-49, 2007-1 CB 1300.

108.23 *Id.*

108.24 *See* Treas. Reg. § 1.1503(d)-1(b)(5)(i). For purposes of determining the amount of a DCL, only the items of the DRC generated during the period that it qualifies as a DRC are taken into account. *See* Treas. Reg. § 1.1503(d)-5(e).

108.25 *See* Treas. Reg. § 1.1503(d)-5(b)(2).

108.26 *See* Treas. Reg. § 1.1503(d)-1(b)(5)(ii).

108.27 *See* Treas. Reg. § 1.1503(d)-5(c)(1)(ii).

108.28 *Id.*

108.29 *See* Treas. Reg. § 1.1503(d)-5(c)(1)(i).

108.30 *See* Treas. Reg. § 1.1503(d)-5(c)(1)(iii).

108.31 *See* Treas. Reg. § 1.1503(d)-5(c)(2)(i).

108.32 *Id.*

108.33 *See* Treas. Reg. § 1.1503(d)-5(c)(4).

Hybrid Entity Separate Unit and Transparent Entity. A hybrid entity separate unit or transparent entity looks to the items recorded in the domestic owner's books and records for purposes of computing its DCL.[108.34] But this applies only to the extent the items are reflected in the records of the hybrid entity separate unit or transparent entity, adjusted to comply with U.S. tax principles.[108.35] The treatment for foreign tax purposes is not a consideration.[108.36] The Commissioner may reallocate items attributed to the transparent entity or hybrid entity if the Service finds that the booking practices of the transparent entity or hybrid entity separate unit have a principal purpose of avoiding the principles of *IRC Section 1503(d)*.[108.37] The items of income, gain, deduction, and loss that are recorded on the books and records of a disregarded entity, partnership, or grantor trust owned by a hybrid or transparent entity (directly or indirectly, other than through a hybrid entity or transparent entity) are treated as reflected on the books and records of the hybrid entity or transparent entity.[108.38] With respect to the DCL of a combined separate unit, each separate unit is first attributed items of income, gain, deduction and loss, and the combined separate unit then takes into account all of the items attributable to the individual separate units.[108.39]

[iv] Domestic Use Limitation

SRLY Limitation. Generally, a domestic use of a DCL is impermissible (i.e., the "domestic use limitation").[108.40] The limitation applies even if there is not a foreign affiliate or a foreign consolidation regime.[108.41] The regulations explain that the domestic use limitation is applicable even in the absence of the current ability to utilize such loss in a foreign jurisdiction because there may be an affiliate acquired in a later year or there might be a sale, merger, or similar transaction that allows for a foreign use of the DCL.[108.42]

If the domestic use limitation applies, the DCL is treated as a loss incurred by the DRC or separate unit in a "separate return limitation year" (SRLY).[108.43] Specifically, taxable income (or loss) or consolidated taxable income (or loss) is computed without consideration of the items of deduction and loss that compose the DRC's or separate unit's DCL (i.e., the "SRLY limitation").[108.44] The DCL that is subject to the SRLY limitation may be carried forward or back for use in other tax years as a separate NOL carryover or carryback of the DRC or separate unit arising in the year incurred.[108.45] A separate unit or

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108.34 *See* Treas. Reg. § 1.989(a)-1(d) (defining "books and records").

108.35 *See* Treas. Reg. § 1.1503(d)-5(c)(3)(i).

108.36 *Id.*

108.37 *See* Treas. Reg. § 1.1503(d)-5(c)(3)(i).

108.38 *See* Treas. Reg. § 1.1503(d)-5(c)(3)(ii).

108.39 *See* Treas. Reg. § 1.1503(d)-5(c)(4)(ii). The regulations provide rules for attributing gain or loss on the disposition of a separate unit or transparent entity.

108.40 *See* Treas. Reg. § 1.1503(d)-4(b). A "domestic use" of a DCL occurs "when the dual consolidated loss is made available to offset, directly or indirectly, the income of a domestic affiliate (other than the dual resident corporation or separate unit that, in each case, incurred the dual consolidated loss) in the taxable year in which the dual consolidated loss is recognized, or in any other taxable year," even if the foreign taxable income is or will not be subject to U.S. tax and even if the DCL does not offset foreign taxable income. Treas. Reg. § 1.1503(d)-2. A domestic use is considered to occur in the year the DCL is included in the consolidated group, unaffiliated DRC, or unaffiliated domestic owner's taxable income. It does not matter if there is no tax benefit resulting from the inclusion. A domestic affiliate is a member of an affiliated group without applying the exceptions in IRC Section 1504(b) (other than IRC Section 1504(b)(3)). A domestic owner, a separate unit, and a transparent entity are also considered a domestic affiliate. *See* Treas. Reg. § 1.1503(d)-1(b)(12).

108.41 *See* Treas. Reg. § 1.1503(d)-6(a)(2).

108.42 *Id.*

108.43 The loss is subject to all of the SRLY limitations under Treas. Reg. § 1.1502-21(c), with certain modifications. *See* Treas. Reg. § 1.1503(d)-4(c)(3).

108.44 *See* Treas. Reg. § 1.1503(d)-4(c)(1) and (2).

108.45 *Id.* For this purpose, the DCL rules adopt the SRLY cumulative register concepts of Treas. Reg. § 1.1502-21(c). *See, e.g.*, GLAM 2011-002 (Aug. 1, 2011) (illustrating the basic cumulative approach under Treas. Reg. § 1.1503(d)-4(c), for absorption of a DCL in the year recognized). There is no guidance addressing the consolidated group years taken into account in the cumulative SRLY computation transparent entity of a DRC is treated as a U.S. corporation that filed a consolidated return with the unaffiliated or affiliated DRC.[108.46]

Example:

Effect on domestic affiliate. P, a U.S. corporation, owns *DE*, a Country X corporation that is disregarded for U.S. tax purposes. *P*'s interest in *DE* is a Country X separate unit, and the *P* consolidated group has consolidated taxable income in year 2. In Years 1 and 2, the items of income, gain, deduction, and loss attributable to *DE* are as follows:

Item	Year 1	Year 2
Sales income	$100	$160
Salary expense	($ 75)	($ 75)
R&E expense	($ 50)	($ 50)
Interest expense	($ 25)	($ 25)
Income/(DCL)	($ 50)	$ 10

P does not make a domestic use election with respect to the Year 1 DCL attributable to *DE*, and the Year 1 DCL of $50 is treated as a loss incurred by a separate domestic corporation and is subject to the limitations described above. *P* must compute its taxable income for Year 1 without taking into account the $50 DCL. The income consists of a pro rata portion of the expenses taken into account in calculating the Year 1 DCL. Thus, the items of the DCL that are not taken into account by *P* in computing its taxable income are as follows: $25 of salary expense ($75/$150 x $50); $16.67 of research and experimental expense ($50/$150 x $50); and $8.33 of interest expense ($25/$150 x $50). The remaining amounts of each of these items, together with the $100 of sales income, are taken into account in the taxable income on a pro rata basis.

The Year 1 $50 DCL is carried forward and is available to offset the $10 of income attributable to *DE* for the purposes of calculating the *P* consolidated group's consolidated taxable income in Year 2. A pro rata portion of each item of deduction or loss included in such DCL is considered to be used to offset the $10 of income, as follows: $5 of salary expense ($25/$50 x $10); $3.33 of research and experimental expense ($16.67/$50 x $10); and $1.67 of interest expense ($8.33/$50 x $10). The remaining amount of each item will continue to be subject to the domestic use limitation.[108.47]

Elimination of a DCL. A DCL subject to the domestic use limitation rule is generally not carried to another corporation in a *IRC Section 381(a)* transaction.[108.48] There are certain exceptions, including a reorganization described in *IRC Section 368(a)(1)(F)*

for DCL purposes. One possibility is to take into account the years that are relevant for general SRLY purposes (i.e., as far back as 1991 or 1997, as applicable). For the general SRLY mechanics, *see* § 42.02[3][b] (cumulative contribution to consolidated taxable income). Another possibility is to take into account years that are relevant for more general DCL purposes. It certainly should be reasonable to apply the general SRLY approach, and perhaps the government's failure to address the issue makes other approaches reasonable as well. For additional commentary on GLAM 2011-002, *see, e.g.*, Parillo, *IRS Clarifies Application of U.S. Dual Consolidated Loss Rules*, 132 Tax Notes 666 (Aug. 15, 2011); Freidel & DeGregorio, *Should the DCL Rules Treat NOLs Like SRLY-Limited BILs*?, 38 J. Corp. Tax'n 45 (Nov./Dec. 2011).

108.46 *See* Treas. Reg. § 1.1503(d)-4(c)(1) and (2).

108.47 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 29*.

108.48 *See* Treas. Reg. § 1.1503(d)-4(d)(1)(i).

in which the resulting corporation is a U.S. corporation,[108.49] an acquisition described in *IRC Section 381(a)* of a DRC's assets by another DRC that is resident in (or subject to tax in) in the same jurisdiction as the acquired DRC,[108.49.1] and an acquisition described in *IRC Section 381(a)* of a separate unit (perhaps among other assets) by a domestic corporation that is a domestic owner of the separate unit after the acquisition.[108.49.2]

A DCL of a domestic owner attributable to a separate unit that is subject to the domestic use limitation is eliminated when the separate unit status terminates.[108.50] This can apply if there is a dissolution, liquidation, termination, sale or other disposal of the separate unit, but there are certain exceptions.[108.51]

Example:

Dual consolidated loss limitation applied to a separate unit transferred in a Section 381 transaction. S, a U.S. corporation and a member of the *P* consolidated group, owns *DE*, a Country X corporation that is disregarded for U.S. tax purposes (Country X separate unit), which in turn owns *FB*, a Country X corporation. In Year 1, a DCL is attributable to *DE*, and *P* does not make a domestic use election with respect to the loss. At the beginning of Year 2, *S* transfers its entire interest in *DE*, and thus its entire indirect interest in *FB*, to *FS*, a Country X corporation subject to tax on its worldwide income or on a residence basis in a transaction described in *IRC Section 381*. As a result of the transfer, *DE* ceases to be a separate unit of *S*, and it is not a separate unit of any other member of the *P* consolidated group. No exceptions apply because *FS* is not a domestic corporation. Thus, the Year 1 DCL attributable to *DE* is eliminated.[108.52]

Tainted Income. After a corporation ceases to be a DRC, its prior DCLs subject to the domestic use limitation cannot offset tainted income earned by the corporation.[108.53] Tainted income is: (1) income or gain recognized on the sale or other disposition of tainted assets, and (2) income derived from holding tainted assets.[108.54] Tainted assets include assets acquired by a domestic corporation in a nonrecognition transaction, assets otherwise transferred to the corporation as a contribution to capital, and assets otherwise received from a separate unit or a transparent entity owned by such domestic corporation, at any time during the three taxable years immediately before the year in which the corporation ceases to be a DRC or at any time thereafter.[108.55] If a corporation did not have a DCL (or a carryforward of a DCL) in the taxable year in which the assets were acquired, or the assets were acquired as replacement property in the ordinary course of business, a DCL of a DRC may offset income generated by the assets, and the associated assets will not be treated as tainted assets.[108.56]

[v] Exceptions to Domestic Use Limitation

Domestic use of a DCL is allowable if there is not an actual or deemed foreign use of the DCL, as defined below. But the DRC or U.S. owner of a separate unit generally must elect to use the loss as described below.

108.49 *See* Treas. Reg. § 1.1503(d)-4(d)(2)(i).

108.49.1 *See* Treas.Reg. § 1.1503(d)-4(d)(2)(ii).

108.49.2 *See* Treas. Reg. § 1.1503(d)-4(d)(2)(iii)(A)(1).

108.50 *See* Treas. Reg. § 1.1503(d)-4(d)(1)(ii).

108.51 *See* Treas. Reg. § 1.1503(d)-4(d)(2)(iii)(A)(1), (A)(2) and (B).

108.52 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 21*.

108.53 *See* Treas. Reg. § 1.1503(d)-4(e)(1). This rule is applicable only in the circumstance that the DRC's DCLs survive the cessation of DRC status (e.g., following an "inbound" reorganization described in IRC Section 368(a)(1)(F)).

108.54 *See* Treas. Reg. § 1.1503(d)-4(e)(2)(i).

108.55 *See* Treas. Reg. § 1.1503(d)-4(e)(3).

108.56 *See* Treas. Reg. §§ 1.1503(d)-4(e)(4), 1.1503(d)-7(c), *Ex. 22*.

Domestic Use Election. A domestic affiliate may include a DCL in its calculation of taxable income or loss if the consolidated group, unaffiliated DRC, or unaffiliated domestic owner (i.e., "electors") files a domestic use election agreement in the manner prescribed by the regulations.[108.57] By filing the agreement, the taxpayer certifies that there has not been, and will not be, for at least five years after the year in which the DCL was incurred (i.e., the "certification period"), any foreign use (as defined below) of the DCL.[108.58] The domestic use agreement must be filed by the due date (including extensions) of the U.S. income tax return for the tax year in which the DCL is incurred,[108.59] and a certification must be submitted by the due date (including extensions) of its income tax return for each year during the five-year certification period.[108.60]

Elective Agreement Between the U.S. and a Foreign Country. A DCL can offset income of a domestic affiliate if there is an agreement between the U.S. and a foreign country that allows an elective procedure for losses in a particular year to be used to offset income in only one country.[108.61] The U.S. has reached only limited agreements with other jurisdictions.[108.62]

No Possibility of Foreign Use. There is no limitation on the domestic use of a DCL if the taxpayer can demonstrate to the satisfaction of the Commissioner that there is no foreign use in the year the DCL is incurred, and that there is no possibility of foreign use in any other year.[108.63] A statement must be attached to, and filed by the due date (including extensions) of, the U.S. income tax return for the taxable year of incurrence of the DCL.[108.64]

[vi] Foreign Use

The following principles identify when direct or indirect foreign use of a DCL occurs. Several exceptions to these rules are included in the 2007 regulations.[108.65]

108.57 *See* Treas. Reg. § 1.1503(d)-6(d).

108.58 The certification period has been reduced from the 15-year period in the 1992 regulations. *See* former Treas. Reg. § 1.1503(d)-1(b)(20) (1992).

108.59 *See* GLAM 2008-001 (Jan. 22, 2008) (guidance to taxpayers who fail to timely file domestic use elections and related annual certifications that are not uncovered until after expiration of the statute of limitations for the tax year in which the DCL was incurred).

108.60 *See* Treas. Reg. § 1.1503(d)-6(g). The certification must follow the requirements under Treas. Reg. § 1.1503(d)-6(g).

108.61 *See* Treas. Reg. § 1.1503(d)-6(b).

108.62 *See* United Kingdom/United States Dual Consolidated Loss Competent Authority Agreement, *Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (Oct. 6, 2006), *reprinted in* 2006 TNT 196-24 (LEXIS, Fedtax Library, TNT File).

108.63 *See* Treas. Reg. § 1.1503(d)-6(c). This is intended to be a narrow exception to the domestic use limitation. *See* REG-102144-04, 2005-1 C.B. 1297 (the exception "will apply only in rare and unusual circumstances").

108.64 *See* Treas. Reg. § 1.1503(d)-6(c)(1)(ii). The statement must follow the requirements under Treas. Reg. § 1.1503(d)-6(c)(2).

108.65 *See* Treas. Reg. § 1.1503(d)-3(c).

The exception under Treas. Reg. § 1.1503(d)-3(c)(4) ("(c)(4) exception") generally provides that, in the case of a DCL attributable to an interest in a hybrid entity partnership or hybrid entity grantor trust, or to a separate unit owned indirectly through a partnership or grantor trust, a foreign use will not be considered to occur if the foreign use is solely the result of another person's ownership of an interest in the partnership or grantor trust, as applicable, and the allocation or carry forward of a deduction or loss composing the DCL that results from the ownership. A limitation under Treas. Reg. § 1.1503(d)-3(c)(4)(iii) ("(c)(4) limitation") renders the (c)(4) exception inapplicable if, at any time following the year in which the DCL is incurred, there is more than a *de minimis* reduction in the domestic owner's percentage interest in the partnership or grantor trust. Thus, a foreign use will be deemed to occur at the time the reduction exceeds the *de minimis* amount. *See* Treas. Reg. § 1.1503(d)-3(c)(5). A reduction in interest may result from another person acquiring an interest in the foreign branch or hybrid entity through a sale, exchange, contribution, or other means. *See* Treas. Reg. § 1.1503(d)-3(c)(5)(iii). The regulations do not address how to determine whether there has been more than a *de minimis* reduction in the domestic owner's percentage interest in the partnership or grantor trust, nor do they specify how the (c)(4) limitation applies to a

Direct Foreign Use. Foreign use is deemed to occur when a DCL, or any portion thereof, is made available to offset, directly or indirectly, an item treated as income or gain under foreign laws.[108.66] Applying U.S. tax principles, the items offset must be an item of either a foreign corporation or a direct or indirect owner of an interest in a hybrid entity (as long as the interest is not a separate unit).[108.67] A deduction need not offset gain or income under foreign law or be regarded as income for U.S. tax purposes.[108.68] For example, a DRC might be included in a foreign consolidated return.[108.69]

Indirect Foreign Use. With certain exceptions, an indirect foreign use occurs when deductions or losses are taken into account for foreign tax purposes, but do not give rise to corresponding income or gain for U.S. tax purposes, and the deduction or loss composing the DCL is made indirectly available for foreign use.[108.70]

Ordering Rules for Determining Foreign Use. Where a foreign country allows for the use of losses of a DRC or a separate unit, but does not provide rules for the order in which they are used in a taxable year, any net loss, or net income, of the DRC or separate unit is treated as first offsetting net income, or loss, recognized by its affiliates in the same taxable year before considering carryover losses.[108.71] A DRC or separate unit with losses from different tax years under foreign law is treated as first using the losses that would not constitute a triggering event resulting in the recapture of the DCL.[108.72] The DRC or separate unit then uses the losses from the most recent taxable year from which a loss may be carried forward or back under foreign law.[108.73] Losses of different types (e.g., capital losses and ordinary losses) available for foreign use and incurred in the same taxable year are deemed to be used on a pro rata basis.[108.74]

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combined separate unit. Accordingly, there was concern that the (c)(4) limitation for partnership and grantor trust interests applied on an uncombined basis. In GLAM 2008-007 (June 25, 2008), the Service addressed how the (c)(4) limitation on the (c)(4) exception applies to three scenarios involving the common parent of a consolidated group with an interest in a combined separate unit that includes a partnership. The GLAM provides that the (c)(4) exception and the (c)(4) limitation should be calculated with respect to the combined unit and not on an uncombined basis. In addition, GLAM 2009-011 (Oct. 2, 2009) provides further guidance regarding the effect of the *de minimis* exception. Specifically, in Scenario 2, the Service concluded that the sale to an unrelated foreign corporation of 2% of a domestic corporation's interest in a separate unit for which a domestic use election had been made qualified for the *de minimis* exception to foreign use; and, more notably, that a subsequent transfer of such interest by the unrelated foreign corporation to a wholly owned foreign subsidiary also qualified for the *de minimis* exception.

108.66 *See* Treas. Reg. § 1.1503(d)-3(a)(1). *See also* GLAM 2009-011 (Oct. 2, 2009) (in Scenario 1, where a wholly owned foreign corporation elected to be disregarded mid-year, the Service concluded that a domestic use election is not permitted for a DCL attributable to the period following the check-the-box election because (i) under local country law, one or more of the deductions or losses are available to offset any item of income or gain incurred during such year, and (ii) since the entity is classified as a foreign corporation under U.S. tax principles for the portion of the year before becoming disregarded, an item of income or gain able to be offset by a deduction or loss of the DCL would be considered under U.S. tax principles to be an item of a foreign corporation; the Service also noted that there may be a foreign use even if the foreign corporation elected to be disregarded effective as of the start of the year for which there is a DCL, as a result of differences in the tax treatment of items under foreign and U.S. tax laws).

108.67 *Id. See also* GLAM 2009-011 (Oct. 2, 2009) (Scenario 3 illustrates that (i) a sale of a portion of an interest in a foreign entity classified as a partnership for U.S. purposes by a U.S. corporation to another U.S. corporation does not result in a foreign use of a DCL under Treas. Reg. § 1.1503(d)-3(a), because the item of income or gain is not considered under U.S. tax principles to be an item of a foreign corporation (i.e., it is an item of income or gain of a U.S. corporation), and (ii) the application of the Treas. Reg. § 1.1503(d)-3(c)(4)(iii) limitation to the (c)(4) exception cannot itself create a foreign use if there is not a foreign use under the general rules, or if another exception to the foreign use rules applies).

108.68 *See* Treas. Reg. § 1.1503(d)-3(b).

108.69 *See, e.g.,* Treas. Reg. § 1.1503(d)-7(c), *Ex. 6*.

108.70 *See* Treas. Reg. § 1.1503(d)-3(a)(2)(i).

108.71 *See* Treas. Reg. § 1.1503(d)-3(d)(1).

108.72 *See* Treas. Reg. § 1.1503(d)-3(d)(2).

108.73 *Id.*

108.74 *See* Treas. Reg. § 1.1503(d)-3(d)(3).

Example:

No foreign use—absence of foreign loss ordering rules. P, a U.S. corporation, owns *DRC*, a dual resident corporation and a member of the *P* consolidated group. *DRC* owns *FS*, a Country X corporation subject to tax on worldwide income on a residence basis. Under the Country X consolidation regime, a consolidated group may elect in any year to use all or a portion of the losses of one consolidated group member to offset income of other consolidated group members. If no election is made in a year in which losses are generated by a consolidated group member, the losses carry forward and are available, at the election of the consolidated group, to offset income of consolidated group members in subsequent taxable years. Country X law does not provide ordering rules for determining when a loss from a particular taxable year is used because, under Country X law, losses never expire. In addition, Country X law does not provide ordering rules for determining when a particular type of loss (e.g., capital or ordinary) is used. In Year 1, *DRC* incurs an $80 capital loss and an $80 NOL that is a DCL, while *FS* generates $60 of capital gain in Year 1 that, for Country X purposes, can be offset by capital losses and NOLs. Under the laws of Country X, *DRC* elects to use $60 of its $160 total Year 1 loss to offset *FS*'s $60 of capital gain, and the remaining $100 carries forward. In Year 2 and Year 3, *DRC* incurs another $100 NOL, while *FS* generates no further income or loss. *DRC*'s losses in Year 2 and Year 3 are DCLs. *P* makes a domestic use election with respect to both DCLs. In Year 4, *DRC* incurs a $10 NOL and *FS* generates $125 of income. Country X law permits, on an election, *FS*'s $125 of income to be offset by losses (including carryover losses from prior years) of other group members. Accordingly, *DRC* elects to use $125 of its accumulated losses to offset $125 of income in Year 4. Under the ordering rules, a pro rata amount of *DRC*'s Year 1 NOL ($30) and capital loss ($30) is considered to offset *FS*'s Year 1 $60 capital gain, resulting in a portion of *DRC*'s Year 1 $80 DCL being put to a foreign use. *DRC*'s $10 Year 4 NOL is also a DCL, and under the ordering rules, it is considered to offset $10 of *FS*'s Year 4 $125 of income, with $50 of capital loss carryover and $50 of ordinary loss from Year 1 considered to offset $100 of *FS*'s Year 4 income because the income is first deemed to have been offset by losses the use of which would not constitute a triggering event that would result in the recapture of a DCL. The remaining $15 of *FS*'s Year 4 income is considered offset by losses from Year 3 because it is the most recent taxable year from which a loss may be carried forward. Thus, a portion of the Year 3 DCL has been put to a foreign use and, as discussed below, the entire Year 3 DCL is recaptured.[108.75]

Exceptions to Foreign Use. There are several exceptions to the basic definition of foreign use:[108.75.1]

(i) Where foreign law enables a foreign use by way of an election, or through a sale, merger or similar transaction, and there is no election, sale, merger or similar transaction.[108.76]

(ii) To the extent a DCL is made available under foreign law both to offset income that would constitute a foreign use and to offset income that would not constitute a foreign use, and such foreign law does not provide allocation rules determining which income the DCL offsets.[108.76.1]

(iii) If the foreign use is solely the result of another person's ownership of an interest in the partnership or grantor trust to which the DCL is attributable and of the allocation or carry forward of an item of deduction or loss composing such DCL as a result of such ownership.[108.76.2] Without this exception, a domestic corporation's interest in a foreign hybrid partnership could regularly give rise to DCLs for which there is a foreign use, because the foreign hybrid partnership's losses could be carried forward under foreign law to offset its future

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108.75 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 12*.

108.75.1 In addition to the specifically enumerated exceptions to foreign use described below, the Service may also provide exceptions through guidance published in the Internal Revenue Bulletin. *See* Treas Reg. § 1.1503(d)-3(c)(9). We are unaware of any such additional guidance, and as of the issuance of GLAM 2009-011 (Oct. 2, 2009), *reprinted in* ***2009 TNT 195-21*** (LEXIS, Fedtax Library, TNT File), the Service stated that no further exceptions had been provided.

108.76 *See* Treas. Reg. § 1.1503(d)-3(c)(2).

108.76.1 *See* Treas. Reg. §§ 1.1503(d)-3(c)(3); 1.1503(d)-7(c), *Ex 11*.

108.76.2 *See* Treas. Reg. § 1.1503(d)-3(c)(4)(i); 1.1503(d)-7(c), *Ex 13*. In the case of a combined separate unit under Treas Reg. § 1.1503(d)-1(b)(4)(ii), this exception may be applied to the portion of the DCL attributable to the individual separate unit that qualifies income, which includes income attributable to its other partners. For example, if one of the foreign hybrid partnership's other partners were a foreign corporation, then without this exception there would be a foreign use of the DCL by reason of the foreign corporation's ability to use the loss carryforward of the hybrid partnership.

(iv) If the DCL is made available solely as a result of a *de minimis* reduction in the domestic owner's interest in the separate unit.[108.76.3] *De minimis* is generally defined as less than 10% during any 12-month period and less than 30% in aggregate since the DCL was incurred. Without this exception, for example, a sale of just 5% of a domestic corporation's interest in a foreign hybrid partnership to a foreign corporation would cause a foreign use of the entire DCL attributable to the foreign hybrid partnership.

(v) Where a DCL is made available solely as a result of an asset transfer by a separate unit or DRC in which the transferee takes an asset basis equal to the separate unit or DRC's asset basis.[108.76.4] For example, if depreciation deductions are taken in a foreign jurisdiction in a later year as compared to the US, a carryover basis asset transfer could give rise to double basis recovery for the same economic basis—once in the US before the transfer, and again in the foreign jurisdiction after the transfer.[108.76.5] This exception generally allows such a double basis recovery if less than 10% of the separate unit's or DRC's asset basis is transferred during any 12-month period, and less than 30% of such asset basis is transferred in aggregate since the DCL was generated.

(vi) If the foreign use is available solely as a result of an item composing a DCL being made available through the assumption of liabilities of a DRC or separate unit.[108.77] For example, if ordinary course expenses deductible by a separate unit or DRC for US income tax purposes in one year are assumed by a foreign person and then are deductible by the foreign person in a later year, this exception may apply.[108.77.1]

(vii) Where an acquiring domestic corporation or consolidated group acquires more than 90%, but less than 100%, of the dual resident corporation or separate unit immediately after the transaction, no foreign use is deemed to occur, solely as a result of the less than 10% ownership by persons other than the acquiring domestic corporation or consolidated group.[108.77.2]

Mirror Legislation Rule. There will be a deemed foreign use if the foreign income tax laws deny any opportunity for foreign use of the DCL in the year in which it is incurred (i.e., the "mirror legislation rule").[108.78] The regulations provide a limited "stand-alone" exception that is applicable if, in the absence of the mirror legislation, no item of deduction or loss composing the DCL of the DRC or separate unit would otherwise be available for a foreign use in the taxable year in which the DCL was incurred.[108.79] To qualify for the stand-alone exception, the taxpayer must file a domestic use agreement and address the additional items listed in the regulations.[108.80]

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for the exception. Treas. Reg. § 1.1503(d)-3(c)(4)(ii). This exception cannot be applied if the domestic corporation's ownership percentage in the partnership or grantor trust undergoes more than a *de minimis* reduction in interest. Treas. Reg. § 1.1503(d)-3(c)(4)(iii).

108.76.3 *See* Treas. Reg. §§ 1.1503(d)-3(c)(5); 1.1503(d)-7(c), *Ex 5*.

108.76.4 *See* Treas. Reg. § 1.1503(d)-3(c)(6).

108.76.5 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex 15*.

108.77 *See* Treas. Reg. § 1.1503(d)-3(c)(7)(i). This applies only if the availability results from the liabilities giving rise to the deduction or loss. This exception is limited to liabilities incurred in the ordinary course of the DRC's, or separate unit's, trade or business. *See* Treas. Reg. § 1.1503(d)-3(c)(7)(ii).

108.77.1 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex 16*.

108.77.2 *See* Treas. Reg. § 1.1503(d)-3(c)(8).

108.78 *See* Treas. Reg. § 1.1503(d)-3(e)(1).

108.79 *See* Treas. Reg. § 1.1503(d)-3(e)(2)(i).

108.80 *See* Treas. Reg. § 1.1503(d)-3(e)(2)(ii).

Example:

No foreign use—absence of foreign loss usage ordering rules. P, a U.S. corporation, owns *DRC*, a dual resident corporation, and a member of the *P* consolidated group. *DRC* owns *FS*, a Country X corporation subject to tax on its worldwide income or on a residence basis. In Year 1, *DRC* incurs a $100 DCL. To prevent corporations like *DRC* from offsetting its losses against both income of affiliates in Country X and income of foreign affiliates under the tax laws of another country, Country X mirror legislation prevents a corporation subject to the income tax of another country on its worldwide income or on a residence basis from using the Country X form of tax consolidation. Accordingly, the Country X mirror legislation prevents the DCL from being made available to offset income of *FS*. Because the DCL is subject to Country X's mirror legislation, there is a deemed foreign use of the DCL. The stand-alone exception to the mirror rule does not apply because, absent the mirror legislation, all or a portion of the DCL would be available to offset *FS*'s income under the Country X consolidation regime. This is the case even if Country X did not recognize *DRC* as having a Year 1 loss. (If the facts were the same, but that *P* owned *DE* (rather than *DRC*), and the Year 1 $100 DCL was attributable *DE* (rather than *DRC*), the Country X mirror legislation only applies to Country X DRCs and, therefore, does not apply to losses attributable to *P*'s interest in *DE*, so the mirror legislation rule would not deny such loss from being put to a foreign use.)[108.81]

[vii] Domestic Use Election Triggering Event Consequences

In general. In general, if there is a triggering event with respect to a DCL during the certification period, the taxpayer with a prior domestic use election must recapture and report as ordinary income the amount of the DCL and pay interest.[108.82] The following are listed as triggering events in the 2007 regulations:

(1) A foreign use of the DCL.[108.83]

(2) An affiliated DRC or affiliated domestic owner of a separate unit ceases to be a member of the consolidated group that made the domestic use election. An affiliated DRC or affiliated domestic owner will be considered to cease to be a member of the consolidated group if it is no longer a member of the group or if the group discontinues existence (e.g., it no longer files a consolidated return).[108.84]

(3) An unaffiliated DRC or unaffiliated domestic owner becomes a member of a consolidated group.[108.85]

(4) Fifty percent or more of the DRC's or separate unit's gross assets (measured by the fair market value of the assets at the time of such transaction or, for multiple transactions, at the time of the first transaction) are disposed of in a single transaction or a series of transactions within a 12-month period.[108.86]

(5) Fifty percent or more of the interest in a separate unit (measured by voting power or value at the time of transaction, or for multiple transactions, at the time of the first transaction) of the domestic owner, as

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108.81 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 17*.

108.82 *See* Treas. Reg. § 1.1503(d)-6(e)(1).

108.83 *See* Treas. Reg. § 1.1503(d)-6(e)(1)(i).

108.84 A corporation included in the affiliated group under IRC Section 1504(a) is considered a member of the group. For this purpose, "member" is defined in Treas. Reg. § 1.1502-1(b). A "reverse acquisition" under Treas. Reg. § 1.1502-75(d)(3), where the consolidated group that includes the affiliated DRC or affiliated domestic owner is treated as remaining in existence, is not treated as a triggering event. *See* Treas. Reg. § 1.1503(d)-6(e)(1)(ii).

108.85 *See* Treas. Reg. § 1.1503(d)-6(e)(1)(iii).

108.86 *See* Treas. Reg. § 1.1503(d)-6(e)(1)(iv). Dispositions are disregarded if they occur in the ordinary course of the DRC's or separate unit's trade or business. An interest in another separate unit and the shares of a DRC are not treated as assets of a separate unit or a DRC. A triggering event will not occur if the taxpayer demonstrates, to the satisfaction of the Commissioner, that the transfer of assets did not result in a carryover under foreign law of the DRC's, or separate unit's, losses, expenses, or deductions to the transferee of the assets. *See* Treas. Reg. § 1.1503(d)-6(f)(2)(ii). For purposes of this determination, the exception to foreign use with respect to the assumption of certain liabilities is applicable. Following rebuttal, described below, the domestic use agreement is still effective.

compared to the domestic owner's percentage interest on the last day of the taxable year in which the DCL was incurred, is disposed of in a single transaction or a series of transactions within a 12-month period.[108.87]

(6) An unaffiliated DRC, unaffiliated domestic owner, or hybrid entity separate unit, incurs a DCL and then becomes a foreign corporation.[108.88]

(7) An unaffiliated DRC or unaffiliated domestic owner makes an election to become a RIC, a REIT, or an S corporation.[108.89]

(8) A taxpayer fails to file the annual certification with respect to a DCL.[108.90]

(9) A taxpayer no longer satisfies the conditions required for the stand-alone exception.[108.91]

Triggering Event Exceptions.

(1) Continuing ownership in interests and assets. The following do not constitute triggering events and do not require filing a new domestic use agreement because the ownership is within the same affiliated group or within the same unaffiliated DRC or domestic owner:

(i) an affiliated DRC or affiliated domestic owner ceases to be a member of a consolidated group solely because of a transaction in which a member of the same consolidated group succeeds to the tax attributes of the DRC or domestic owner under section 381;[108.92]

(ii) assets of an affiliated DRC, or assets of, or interests in, a separate unit of an affiliated domestic owner are disposed of, and the assets or interests are acquired by one or more members of the consolidated group that includes the affiliated DRC or affiliated domestic owner, or by a partnership or a grantor trust, but only if immediately after the acquisition more than 90% of the partnership's or grantor trust's interests is owned, directly or indirectly, by members of such consolidated group;[108.93] and

(iii) assets of an unaffiliated DRC, or assets of, or interests in, a separate unit of an unaffiliated domestic owner, are disposed of and the assets or interests are acquired by the unaffiliated DRC, or unaffiliated domestic owner, as applicable, or by a partnership or grantor trust, but only if immediately after the acquisition more than 90% of the partnership's or grantor trust's interests is owned, directly or indirectly, by the unaffiliated DRC or unaffiliated domestic owner.[108.94]

(2) Transactions requiring a new domestic use agreement. Unlike the foregoing transactions, a new domestic use agreement is required to avoid the consequences of a triggering event with respect to multiple-party events and events resulting in a single consolidated group.[108.95] The agreement must follow the format and include the required

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[108.87] *See* Treas. Reg. § 1.1503(d)-6(e)(1)(v).

[108.88] *See* Treas. Reg. § 1.1503(d)-6(e)(1)(vi). For example, a reorganization or an election under Treas. Reg. § 301.7701-3(c).

[108.89] *See* Treas. Reg. § 1.1503(d)-6(e)(1)(vii).

[108.90] *See* Treas. Reg. § 1.1503(d)-6(e)(1)(viii).

[108.91] *See* Treas. Reg. § 1.1503(d)-6(e)(1)(ix). *See also* ILM 200810023 (Nov. 19, 2007) (if more than one triggering event may apply to a transaction, the taxpayers must identify and rebut each potential triggering event, rebutting events requires consideration of all possible scenarios under which losses, expenses, or deductions may either carry over, or be used to offset income of another person, under foreign law, even as a built-in deduction embedded in the basis of the transferred assets, and foreign law is applicable only in determining whether losses, expenses, or deductions carry over to a transferee, or can be used to offset the income of another person, while all other matters, including the substance of a particular transaction and whether losses are made available to another person, are governed by U.S. federal income tax law).

[108.92] *See* Treas. Reg. § 1.1503(d)-6(f)(1)(i).

[108.93] *See* Treas. Reg. § 1.1503(d)-6(f)(1)(ii).

[108.94] *See* Treas. Reg. § 1.1503(d)-6(f)(1)(iii).

[108.95] *See* Treas. Reg. § 1.1503(d)-6(f)(2)(i).

information as provided under the regulations.[108.96] In addition to a new domestic use agreement, in the case of a multiple-party event the original taxpayer must file a statement that is attached to and filed by the due date (including extensions) of its income tax return for the taxable year in which the event occurs. The statement must follow the requirements of the regulations.[108.97] A multiple-party event includes: (i) an affiliated DRC or affiliated domestic owner becoming an unaffiliated domestic corporation or a member of a new consolidated group (other than in a transaction described below with respect to events resulting in a single consolidated group);[108.98] and (ii) disposition of assets of a DRC or assets of, or interests in, a separate unit, in a transaction in which the assets or interests are acquired by an unaffiliated domestic corporation, one or more members of a new consolidated group, or by a partnership or grantor trust, but only if immediately after the disposition, more than 90% of the partnership's or grantor trust's interests is owned, directly or indirectly, by the unaffiliated domestic owner or by members of a new consolidated group.[108.99]

If the multiple-party event triggering exception applies, there is an exception to foreign use where an acquiring unaffiliated domestic corporation or consolidated group owns, directly or indirectly, greater than 90%, but less than 100%, of the transferred assets or interests immediately after the transaction. Specifically, no foreign use will be considered to occur with respect to a DCL of the DRC or separate unit whose assets or interests were acquired, solely as a result of the less than 10% direct or indirect ownership of the acquired assets or interests, by persons other than the acquiring unaffiliated domestic corporation or consolidated group immediately after the transaction.[108.100]

Example:

No foreign use following multiple-party event exception to triggering event. P, a U.S. corporation, owns *DE*, a Country X corporation disregarded for U.S. tax purposes. In Year 1, *DE* incurs a $100 DCL and *P* makes a domestic use election with respect to the loss. Partnership *PRS* is owned 95% by *T*, a U.S. corporation unrelated to *P*, and 5% by *FS*, a foreign corporation subject to tax on its worldwide income on a residence basis. At the beginning of Year 3, *PRS* purchases 100% of the interest in *DE* from *P* for cash. For Country X tax purposes, the $100 loss incurred by *DE* in Year 1 carries forward and is available to offset income of *DE* in subsequent years. *P*'s sale of its interest in *DE* is a triggering event, but the sale will qualify for the multiple-party event exception if (i) the *T* consolidated group files a new domestic use agreement with respect to the *DE*'s Year 1 DCL, and (ii) the *P* consolidated group files a statement with respect to the Year 1 DCL. The domestic use agreement filed by the *P* consolidated group with respect to the Year 1 DCL terminates and has no further effect. In addition, because *DE*'s $100 loss carries forward to subsequent years for Country X purposes, and is available to offset *DE*'s income, there would be a foreign use of the DCL immediately after the sale. It is sufficient that the DCL will be available to offset or reduce income that is considered, under U.S. tax principles, to be an item of *FS*, a foreign corporation. (It would also be a foreign use because *FS* is an indirect owner of an interest in a hybrid entity that is not a separate unit.) But there is no foreign use as a result of *FS*'s 5% interest in *DE*.[108.101]

Events resulting in a single consolidated group include: (i) an unaffiliated DRC or unaffiliated domestic owner becoming a member of a consolidated group;[108.102] and (ii) a consolidated group ceasing to exist due to a transaction described in *Treas. Reg. § 1.1502-13(j)(5)(i)* (relating to acquisitions of the common parent of the consolidated group),

[108.96] *See* Treas. Reg. § 1.1503(d)-6(f)(2)(iii)(A).

[108.97] *See* Treas. Reg. § 1.1503(d)-6(f)(2)(iii)(B).

[108.98] *See* Treas. Reg. § 1.1503(d)-6(f)(2)(i)(A).

[108.99] *See* Treas. Reg. § 1.1503(d)-6(f)(2)(i)(B).

[108.100] *See* Treas. Reg. § 1.1503(d)-3(c)(8).

[108.101] *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 37*.

[108.102] *See* Treas. Reg. § 1.1503(d)-6(f)(2)(ii)(A).

other than a transaction in which any member of the terminating group, or the successor-in-interest of such member, is not a member of the surviving group immediately after the terminating group ceases to exist.[108.103]

(3) Other exceptions. The 2007 regulations provide further exceptions to triggering events in the case of certain deemed transactions and certain compulsory transfers.[108.104]

Consequences of a Triggering Event. Generally, if there is a triggering event, a DRC or domestic owner of the separate unit must recapture as gross income the total amount of the DCL on its income tax return in the taxable year of the triggering event.[108.105] On foreign use of a DCL, the amount is recaptured in the year that includes the last day of the foreign taxable year during which the foreign use occurs.[108.106] An interest charge is also due on the recapture amount and is treated as part of the tax liability for the year.[108.107] But there might be a reduction in the amount of recapture and/or interest charge.[108.108]

Example:

Reduced recapture and interest charge, and reconstituted DCL. S is a member of the *P* consolidated group and owns all of *DE*, a Country X corporation that is disregarded for U.S. tax purposes (Country X separate unit). In Year 1, *DE* incurs a $100 DCL and *P* earns $100. *P* makes a domestic use election with respect to *DE*'s DCL, and *P* is permitted to offset its $100 of income with the $100 DCL. In Year 2, *P* incurs a $30 loss that offsets $30 of income earned by *DE*. In Year 3, *DE* earns $25 of income, and *P* earns $15 of income. In addition, at the end of Year 3, there is a foreign use of the Year 1 DCL that constitutes a triggering event. *S* continues to own *DE* after the triggering event. *S* must recapture $100 (plus applicable interest). But *S* may be able to demonstrate that a lesser amount is subject to recapture. The lesser amount is the amount of the $100 DCL that would have remained subject to the domestic use limitation at the time of the foreign use triggering event if a domestic use election had not been made for the DCL. Although the combined separate unit earned $30 of income in Year 2, there was no consolidated taxable income in that year. As a result, as of the end of Year 2 the $100 DCL would continue to be subject to the domestic use limitation if a domestic use election had not been made for such loss. But the $30 earned in Year 2 can be carried forward to subsequent taxable years and may reduce the recapture income to the extent of consolidated taxable income generated in subsequent years. In Year 3, the *P* group has $40 of consolidated taxable income, and the $100 of recapture income can be reduced by $40. Accordingly, if *S* can adequately document the lesser amount, the amount of recapture income is $60 ($100-$40).[108.109]

In general, the taxable income for the year of recapture does not offset the recapture amount with current, carryover or carry back losses.[108.110] But the taxpayer's NOL carryover that is attributable to the DRC or separate unit that incurred

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108.103 *See* Treas. Reg. § 1.1503(d)-6(f)(2)(ii)(B).

108.104 *See* Treas. Reg. § 1.1503(d)-6(f)(4) and (5).

108.105 *See* Treas. Reg. § 1.1503(d)-6(h)(1).

108.106 *Id.*

108.107 *Id.*

108.108 *See* Treas. Reg. § 1.1503(d)-6(h)(2)(i) and (ii).

108.109 *See* Treas. Reg. § 1.1503(d)-7(c), *Ex. 40*. *DE* may offset the DCL against $15 of *P*'s income in Year 3 according to the "cumulative register" approach of Treas. Reg. § 1.1502-21(c)(1). Because *DE* earned $30 of income in Year 2, but was limited in using the DCL against the income due to *P*'s Year 2 loss, *DE* effectively carries forward the $30 of income to Year 3 through inclusion in its cumulative register. If *P* has income in Year 3, the DCL may offset up to $30 of the income. *See also* GLAM 2011-002 (Aug. 1, 2011) (illustrating the basic cumulative approach under Treas. Reg. § 1.1503(d)-4(c), for absorption of a DCL in the year recognized).

108.110 Treas. Reg. § 1.1503(d)-6(h)(4)(i).

the DCL may offset the recapture amount.[108.111] The taxpayer must demonstrate to the satisfaction of the Commissioner the amount of the carryover.[108.112] The recapture income will be treated as ordinary income and will be treated as having the same character, source, and separate category, for all purposes, including *IRC Sections 904(d)* and *907*, to which the items of deduction or loss composing the DCL were allocated and apportioned, as provided under *IRC Sections 861(b)*, *862(b)*, *863(a)*, *864(e)*, and *865*.[108.113]

Generally, the DRC, or the domestic owner of the separate unit, that incurred the recaptured DCL will be considered to have an NOL ("reconstituted NOL") in an amount equal to the recaptured DCL in the tax year immediately after the year in which the DCL is recaptured.[108.114] The reconstituted NOL will be subject to the domestic use limitation without regard to the exceptions.[108.115] The reconstituted NOL will be available only for carryover to tax years following the tax year of recapture.[108.116] The reconstituted NOL will be treated as if it had been recognized in the tax year in which the recaptured DCL was incurred to determine its carryover period.[108.117] If no domestic use election was made for the loss and the DCL would have been eliminated pursuant to the cessation of separate unit status or to a Section 381(a) transaction, the DRC or domestic owner of the separate unit will not be treated as having a reconstituted NOL.[108.118] If the multiple-party event exception applies, the subsequent taxpayer, as opposed to prior subsequent taxpayer and the original taxpayer, who owns the separate unit or DRC at the time of the subsequent triggering event will be subject to the recapture rules.[108.119] The subsequent taxpayer takes into account the recapture tax amount and prepares a statement with the computation in accordance with the regulations.[108.120]

Rebuttals to Triggering Events. The domestic use agreement filed with respect to a DCL will terminate before the end of the certification period if: (i) the taxpayer can rebut the presumption of a triggering event;[108.121] (ii) an event is not a triggering event as a result of the application of one of the exceptions (relating to events requiring a new domestic use agreement), and any new domestic use agreement filed in connection with the event will remain in effect; or (iii) the DCL is recaptured.[108.122] A domestic use agreement filed with respect to a DCL will terminate at the end of a tax year if the taxpayer demonstrates, to the satisfaction of the Commissioner, that there will be no foreign use of the DCL as of the end of the tax year or in any other year, and files a statement by the due date (including extension) in accordance with the regulations.[108.123]

[viii] Transition Rules from 1992 Regulations to 2007 Regulations

Transition of Existing (g)(2)(i) Agreements. Under the 1992 regulations, a taxpayer can use a DCL to offset income of a domestic affiliate but must certify for 15 years that the DCL has not, and will not, be used to offset the income of any other person under foreign income tax laws. The taxpayer must file an agreement in accordance with the regulations

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108.111 *See* Treas. Reg. §§ 1.1502-21(b)(2)(iv) and 1.1503(d)-5.

108.112 *See* Treas. Reg. § 1.1503(d)-6(h)(4)(i) and (ii).

108.113 *See* Treas. Reg. § 1.1503(d)-6(h)(5).

108.114 *See* Treas. Reg. § 1.1503(d)-6(h)(6)(i). If a U.S. corporation (transferee) acquires the assets of the domestic owner or DRC in a Section 381(a) transaction, the transferee will be treated as the DRC or domestic owner, as applicable.

108.115 *Id.*

108.116 *Id.*

108.117 *Id.*

108.118 *See* Treas. Reg. § 1.1503(d)-6(h)(6)(ii).

108.119 *See* Treas. Reg. § 1.1503(d)-6(h)(3)(ii)(A). If the subsequent taxpayer does not pay the income tax liability, including the recapture tax amount, the Service may collect the tax liability attributable to the recapture tax amount in full or in part from the original taxpayer and/or from any prior taxpayer. *See* Treas. Reg. § 1.1503(d)-6(h)(3)(iv)(B).

108.120 *See* Treas. Reg. § 1.1503(d)-6(h)(3)(ii)(B) and (h)(3)(iii).

108.121 The taxpayer must file a statement for the rebuttal of the presumption of the triggering event in accordance with the regulations.

108.122 *See* Treas. Reg. § 1.1503(d)-6(j)(1).

108.123 *See* Treas. Reg. § 1.1503(d)-6(j)(2).

(i.e., the "(g)(2)(i) agreement").[108.124] The 2007 regulations treat a (g)(2)(i) agreement as a domestic use election and consider it to apply only for tax years up to and including the fifth tax year following the year in which the DCL was incurred. Thereafter, the DCL will have no effect.[108.125]

Under the 1992 regulations, if the taxpayer filed a (g)(2)(i) agreement and entered into a closing agreement with the Service, the acquisition of a DCL by an unaffiliated domestic corporation or a new consolidated group did not constitute a triggering event in certain instances. If there was a triggering event, the new taxpayer must be jointly and severally liable for the total amount of recapture of the DCL and interest charge.[108.126] Under the 2007 regulations, taxpayers subject to a closing agreement will be deemed to have satisfied the closing agreement's 15-year certification period requirement if the five-year certification period has passed. The closing agreement must still be in effect and the DCL must not have been triggered and recaptured.[108.127]

Events that occur between April 19, 2007, and before the effective date of the 2007 regulations, with respect to DCLs incurred in tax years beginning on or after October 1, 1992, are ineligible for a closing agreement. But the events are eligible for the multiple-party event exception described above with certain changes. A (g)(2)(i) agreement (as opposed to a domestic use agreement) should be filed, and subsequent triggering events and exceptions have the meaning provided under the 1992 regulations (other than the exception provided under *Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(1)*).[108.128]

Late Filings. Under the 1992 regulations, if a taxpayer missed certain filings with respect to *IRC Section 1503(d)*, the taxpayer had to apply for a discretionary extension of time from the Service.[108.129] By contrast, the 2007 regulations provide an automatic reasonable cause relief standard for all untimely filings with respect to DCLs. The reasonable cause relief applies generally for DCLs incurred in taxable years beginning before the application date of the 2007 regulations.[108.130] Taxpayers with an extension ruling request outstanding as of March 19, 2007 (other than with respect to closing agreements) are not required to use the reasonable cause procedure. If the taxpayer has not yet received a response, the request can be withdrawn in favor of the reasonable cause procedure.[108.131]

The reasonable cause exception provides relief for a person permitted or required to file an election, agreement, statement, rebuttal, computation, or other information pursuant to *IRC Section 1503(d)* and the regulations, but who fails to make such filing in a timely manner. A demonstration must be made to the Service that the failure was due to reasonable cause and not willful neglect.[108.132] All the documents that should have been filed, as well as a written statement explaining the reason for failure, must be attached to an amended return in accordance with the regulations.[108.133]

108.124 *See* Treas. Reg. § 1.1503-2(g)(2)(i) or 1.1503-2T(g)(2)(i).

108.125 *See* Treas. Reg. § 1.1503(d)-8(b)(1).

108.126 *See* former Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(2)(i) (1992).

108.127 *See* Treas. Reg. § 1.1503(d)-8(b)(2).

108.128 *Id.*

108.129 For extensions of regulatory deadlines generally, see, e.g., Treas. Reg. §§ 301.9100-1 through 301.9100-3; Rev Proc 2000-42, 2000-2 CB 394.

108.130 *See* Treas. Reg. § 1.1503(d)-8(b)(3)(i). Taxpayers must still request relief for untimely requests for closing agreements. *See* Treas. Reg. § 1.1503(d)-8(b)(3)(ii).

108.131 *See* Treas. Reg. § 1.1503(d)-8(b)(3)(iii). For withdrawal procedures, *see* Rev Proc 2007-1, 2007-1 CB 1 (and succeeding documents).

108.132 *See* Treas. Reg. § 1.1503(d)-1(c)(1). This generally means demonstrating ordinary care and prudence in meeting tax obligations, but nonetheless not filing within the prescribed time.

108.133 *See* Treas. Reg. § 1.1503(d)-1(c)(2)(i) and (ii).

Basis Considerations. The generally applicable investment adjustment rules apply for purposes of adjusting the basis of stock in an affiliated DRC, an affiliated domestic owner of a separate unit, and other members of an affiliated group.[108.134]

[4] IRC Section 1503(f) Limitation on Losses in Connection with Subsidiary Preferred Dividends

Preferred stock is generally a desirable source of capital when the issuing corporation cannot use the interest deductions that would result from issuing debt.[109] Corporate investors might be interested in holding the preferred stock because of the availability of the dividends received deduction to limit multiple taxation of the issuer's income.[110]

A group's current E&P is consolidated in the common parent under the investment adjustment system.[111] Thus, if the group does not have current E&P as a whole, there will be no current E&P from which the common parent can pay a dividend to its corporate shareholders. Before the Revenue Reconciliation Act of 1989, it was possible for a consolidated group to manage this problem by having shareholders invest in the group through a special-purpose finance subsidiary. The subsidiary would be capitalized with profitable assets and have its own minority, corporate shareholder. Notwithstanding the group as a whole having no consolidated current E&P, the subsidiary would be designed to generate sufficient separate E&P to facilitate dividend distributions to its minority corporate shareholder, enabling the minority shareholder to qualify for a dividends received deduction under *IRC Section 243*.[112] Thus, the income and loss of the group's members would offset, and the profitable subsidiary would pay dividends to its minority corporate shareholders without incurring federal income tax so long as the other group members generate loss to offset the subsidiary's income.[113]

108.134 *See* Treas. Reg. § 1.1503(d)-5(g)(1). For investment adjustments, *see* Treas. Reg. § 1.1502-32.

109 For example, the issuing corporation might have NOLs or credits that shelter its income, or its interest expense might be allocated against foreign-source income, and by reducing the IRC Section 904 limitation, reduce its ability to absorb excess foreign tax credits. *See also* IRC Sections 56(d) (alternative tax net operating loss deduction); 163(e)(5) and (i) (applicable high yield discount obligations); 163(j) (limitation on deduction of interest for certain indebtedness); 172(g) (corporate equity reduction interest losses); 265(a)(2) (disallowance of interest relating to tax-exempt income).

110 *See, e.g.,* IRC Sections 243–47, and 1059; Mundstock, *Taxation of Intercorporate Dividends Under an Unintegrated Regime*, 44 Tax L. Rev. 1 (1988). Because the holders are entitled to the dividends-received deduction, a lower pre-tax rate of return should have to be offered on the preferred stock to provide the holder with an after-tax rate of return that is comparable to the holder's other investments.

111 Treas. Reg. § 1.1502-33(b).

112 At least a 70 percent dividends-received deduction should be available. To qualify for the 80 percent dividends-received deduction, IRC Section 243(c)(2) requires at least 20 percent of the subsidiary's stock (by vote and value) to be owned. For this purpose, stock described in IRC Section 1504(a)(4) is not taken into account.

113 Because IRC Section 1504(a)(2) requires at least 80 percent of the vote and value of a subsidiary's stock to be owned by the group in order for it to remain a member of the affiliated group, there would appear to be a practical limitation on a subsidiary's capacity for equity financing from minority shareholders without causing disaffiliation. *See also* IRC Section 269. If the subsidiary were disaffiliated, it would also be deconsolidated, and the losses of other members of the group would no longer be available to offset the subsidiary's taxable income. Without these losses, the subsidiary would have to use after-tax E&P to support its dividends on the minority-held preferred stock. The most common mechanism to avoid these problems is for the subsidiary to issue preferred stock described in IRC Section 1504(a)(4) (i.e., preferred stock that does not participate in corporate growth to any significant extent), because it is not taken into account under IRC Section 1504(a)(2) in determining affiliation. There may nevertheless be practical limitations, however, because preferred stock might be viewed as outside IRC Section 1504(a)(4) (i.e., it is effectively participating) if it represents too much of the subsidiary's total equity.

IRC Section 1503(f) was enacted in 1989 to prevent this result.[114] It provides that, in determining consolidated taxable income, the losses and credits of other members cannot shelter the portion of the special-purpose subsidiary's income that the subsidiary distributes as a dividend on *applicable preferred stock* to minority shareholders.[115] *IRC Section 1503(f)* is generally effective for taxable years ending after November 17, 1989.[116]

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[114] ***P.L. 101-239***, § 7201 (1989). For a general discussion of IRC Section 1503(f) and earlier legislative proposals considered by Congress, *see, e.g.,* Schler, *Money Market Preferred Stock: Making the Punishment Fit the Crime*, 46 Tax Notes 935 (Feb. 19, 1990); Jassy, *Issuances of Floating Rate Preferred Stock by Special Purpose Subsidiaries of Loss Corporations*, 39 Tax Law. 519 (1986).

The House first proposed legislation to limit special purpose subsidiaries. It would have adopted two provisions, both of which were dropped from the final legislation. *See* H.R. Rep. No. 391 (Part 2), 100th Cong., 1st Sess. 1091–95 (1987). First, if a subsidiary had income or loss allocable to stock owned by nonmembers, consolidation would be denied to the extent of the subsidiary's income or loss allocable to the nonmember stock. Second, the dividends-received deduction would be denied for equity that had significant debt features. The combined effect of these provisions is to both require the subsidiary to pay tax on its own E&P and deny the dividends-received deduction to the subsidiary's minority shareholders. These proposals were never adopted, but were succeeded in 1988 by a House proposed direction that the Secretary of the Treasury conduct a study of the dividends-received deduction (perhaps as part of the study of Subchapter C that was required by the Tax Reform Act of 1986) and report to Congress within six months regarding recommendations. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. 468 (1988). This suggestion was dropped in conference. *See* H.R. Rep. No. 1104 (Vol. II), 100th Cong., 2d Sess. 120 (1988). The final legislative effort began with a House consolidated E&P proposal in 1989, under which distributions by a consolidated subsidiary would be out of E&P if the group as a whole had E&P (but would not be if the group did not have E&P). *See* H.R. Rep. No. 247, 101st Cong., 1st Sess. 1215–19 (1989). This consolidated E&P approach would have produced enormous complexities. *See, e.g.,* American Bar Association, Section of Taxation, *Comments Concerning IRC Section 11201 of "The Revenue Reconciliation Act of 1989" Proposing to Amend IRC Section 1503 of the Internal Revenue Code* (Sept. 26, 1989), *reprinted in* 89 TNT 206-21 (LEXIS, Fedtax Library, TNT File); Paul Rooney, Letter to Senator Lloyd Bentsen (Sept. 6, 1989), *reprinted in* 89 TNT 203-43 (LEXIS, Fedtax Library, TNT File); Lawrence Axelrod, Letter to Kenneth W. Gideon, Assistant Secretary (Tax Policy) (Aug. 18, 1989), *reprinted in* 89 TNT 190-28 (LEXIS, Fedtax Library, TNT File).

This time the Senate reacted by proposing a different provision. The Senate version would disallow the dividends-received deduction on the *disallowed portion* of any *applicable dividend.* An applicable dividend was a dividend (i) on IRC Section 1504(a)(4) stock of a consolidated group member (other than the common parent), (ii) paid out of current E&P of the issuer (determined under IRC Section 316(a)(2)), and (iii) did not exceed the losses and credits of other group members that offset the separately computed taxable income of the issuer. The disallowed portion of the dividend was a percentage equal to the percentage of the issuer's separate taxable income offset by losses and credits of other group members. This formula for disallowing the dividends-received deduction was inherently anti-taxpayer because it presumed the subsidiary's distributions were first out of sheltered income even if the subsidiary has sufficient fully taxed E&P.

The final legislation was like the Senate provision in that it focused on trafficking in tax losses through a consolidated subsidiary that paid dividends on preferred stock out of income that was sheltered from tax by losses of the rest of the group. *See* H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 235 (1989).

[115] IRC Section 1503(f)(1).

[116] Significant transition rules are provided. *See* ***P.L. 101-239***, § 7201(b)(2)–(6) (1989). For example, stock issued after November 17, 1989, pursuant to a written binding contract in effect on that date and at all times thereafter before such issuance is treated as issued on November 17, 1989. Grandfathered stock ceases to be grandfathered if the issuing corporation ceases to be a member of the affiliated group of which it was a member at the time the stock was issued, or becomes a member of any group, unless this event occurs in a transaction that would not result in the recognition of any deferred intercompany gain under Treas. Reg. § 1.1502-13(f) by reason of the acquisition of the entire group. Grandfathered stock also ceases to be grandfathered if the stock is retired or acquired after November 17, 1989 by the issuer or by any member of the affiliated group of which the issuer is a member, unless the retirement or acquisition is pursuant to an obligation to reissue under a binding written contract in effect on November 17, 1989 and at all times thereafter until the stock is reissued. *See* H.R. Conf. Rep. No. 386, 101st Sess. 551–52 (1989).

Query whether a material modification to the preferred stock (e.g., a change in dividend rate) will constitute a *reissuance*? *Cf.* ***Rev Rul 89-122, 1989-2 CB 200***. Generally, auction-rate preferred stock is treated as issued when the contract requiring the auction becomes binding and is not considered issued at the time of each auction conducted pursuant to such commitment. Auction-rate preferred stock will be considered to have been issued before November 18, 1989, however, if (i) the subsidiary was incorporated before July 10, 1989 for the special purpose of issuing this stock, (ii) a rating agency was retained before July 10, 1989 for the purpose of rating the stock, and (iii) the stock was issued before December 17, 1989 (30 days after this provision's date of enactment). For purposes of these

A *subsidiary* that is subject to these rules is any corporation that is a member of a consolidated affiliated group except the common parent corporation.[117] Stock is *applicable preferred stock* if it is (i) described in *IRC Section 1504(a)(4)*, *(ii)* issued after November 17, 1989, and (iii) held by a person other than a member of the same affiliated group as the subsidiary.[118]

A subsidiary's *disqualified separately computed taxable income* is the portion of its separately computed taxable income that does not exceed the dividends distributed by the subsidiary during the taxable year on applicable preferred stock.[119] Thus, only the amount of the subsidiary's separately computed taxable income in excess of the disqualified portion may be offset by a group loss or a group credit item.[120]

A subsidiary's *separately computed taxable income* means its separate taxable income determined under *Treas. Reg. § 1.1502-12* for the taxable year, modified (i) by taking into account capital gains and losses and *IRC Section 1231* gains and losses, (ii) without regard to any NOL or net capital loss carryover or carryback, and (iii) with regard to any adjustments prescribed by the Service.[121] Unless regulations prescribe otherwise, adjustments will be made for any dividends-received deduction available with respect to dividends received by the distributing corporation, as well as other deductions properly allocable to the distributing corporation that were excluded from the computation of separate taxable income under *Treas. Reg. § 1.1502-12*.[122]

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transition rules, stock that has been issued but has never been held by a person not a member of the group is not considered to have been issued. *See* H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 551–52 (1989).

117 IRC Section 1503(f)(3)(C). Thus, IRC Section 1503(f) does not apply to stock issued by the common parent of a consolidated group or by an unconsolidated corporation. Thus, if one of these corporations has E&P, but is unable to absorb additional interest deductions, it can issue preferred stock and effectively sell the benefits of corporate-level deductions to the shareholder through the lower pre-tax rate of return that results from the shareholder's dividends-received deduction.

The rationale for excluding the common parent from IRC Section 1503(f) is unclear. It might be that the common parent is effectively the entire group, and should be on comparable footing to an unconsolidated corporation. This merely calls into question the rationale for excluding unconsolidated subsidiaries. Perhaps, the problem stems from a subsidiary in a consolidated group not being necessarily "at risk" for all of the group's activities that produced the loss.

An alternative rationale might have depended on the operation of the investment adjustment system before its revision in 1994. Before 1995, the interaction of Treas. Reg. §§ 1.1502-32 and 1.1502-33 generally caused any absorption of loss carryovers attributable to subsidiaries to be reflected in the common parent's current E&P (because the loss absorption resulted in a negative stock basis adjustment under former Treas. Reg. § 1.1502-32(b)(2)(ii) (1994) that tiered into E&P under former Treas. Reg. § 1.1502-33(c)(4)(ii) (1994)). Thus, both the common parent and the subsidiary had difficulty using income to pay dividends where the income was offset by a loss carryover. *See* § 51.02 (history). Under the current investment adjustment system, however, stock basis computations under Treas. Reg. § 1.1502-32 are delinked from E&P computations under Treas. Reg. § 1.1502-33 and the subsidiary's loss is reflected in the group's E&P only in the year incurred. Although the subsidiary is still unable to shelter its dividends by reason of IRC Section 1503(f), the investment adjustment system no longer presents a problem for the common parent. Thus, a subsidiary might incur a loss in an earlier year, carry the loss forward under Treas. Reg. § 1.1502-21, and shelter current E&P in a later year that are used by the common parent to pay dividends on preferred stock.

118 IRC Section 1503(f)(3)(D). Applicable preferred stock might be held by noncorporate persons (e.g., individuals or partnerships), and the issuer will be subject to IRC Section 1503(f) even if these shareholders do not benefit from the dividends-received deduction (i.e., the transaction that was the focus of IRC Section 1503(f)). Thus, any issuance of IRC Section 1504(a)(4) preferred stock, even if to a minority noncorporate shareholder, is subject to IRC Section 1503(f) if it occurs after November 17, 1989.

119 IRC Section 1503(f)(3)(A).

120 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 549 (1989). This inherently treats the subsidiary's dividends as being paid *first* out of current taxable income, and any excess as thereafter being out of current E&P in excess of the income.

121 IRC Section 1503(f)(3)(B).

122 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 549 (1989).

Example:

Disqualified separately computed income. P and *S* join in the filing of a consolidated return. *S* has taxable income of $100, and distributes $40 on preferred stock held by nonmembers. *S*'s disqualified separately computed income is $40, and only $60 of *P*'s losses can reduce the group's tax liability on *S*'s income. (If *S*'s taxable income were $20 and a $30 distribution were made in part out of accumulated E&P, the disqualified income would still be $20, and *P*'s losses could not offset any of *S*'s taxable income.)

Neither a *group loss item* nor a *group credit item* can offset the *disqualified separately computed income* (or the tax imposed on that income) of a subsidiary paying dividends on applicable preferred stock for the taxable year.[123] The term *group loss item* includes any NOL, NOL carryover or carryback under *IRC Section 172*, loss from the sale or exchange of any capital asset, and any capital loss carryover or carryback under *IRC Section 1212* of any member other than the subsidiary.[124] A *group credit item* means any credit allowable under the Code, Chapter 1, Subchapter A, Part IV (other than *IRC Section 34*) to any other member of the affiliated group that includes the subsidiary and any carryover or carryback of this credit.[125]

The generally applicable ordering rules for the use of losses or credits generally apply for purposes of *IRC Section 1503(f)*. In addition, losses and credits of all other group members may be used against the income of all other group members, and also against the separately computed taxable income of the distributing subsidiary to the extent this income is not disqualified separately computed taxable income, as permitted by the normal carryover and carryback rules. To the extent that the distributing corporation has loss or credit carryovers and carrybacks, these losses and credits may offset its disqualified separately computed taxable income.[126]

Example:

Disqualified separately computed taxable income. P and *S* join in the filing of a consolidated return. In 1991, *S* issues *IRC Section 1504(a)(4)* stock to a minority shareholder. For the taxable year, *P* has a $100 loss. *S* has $100 of separately computed taxable income, and pays a $60 dividend on the applicable preferred stock. In computing the group's tax for 1990, *P*'s $100 loss cannot offset *S*'s disqualified separately computed taxable income (i.e., the portion of *S*'s separately computed taxable income that does not exceed the $60 dividend paid on the applicable preferred stock). *P*'s loss can offset the remaining taxable income of *S*, however, to the extent otherwise permitted under existing law. Thus, $40 of *P*'s loss may offset $40 of *S*'s taxable income. The remaining $60 of *P*'s loss may be carried back or forward under the normal NOL carryback and carryover rules, provided it may not be used to offset *S*'s previous year (or subsequent year) disqualified separately computed income.[127]

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123 IRC Section 1503(f)(1). The statute does not distinguish a subsidiary having accumulated E&P from one that does not. If the subsidiary has accumulated E&P, an appropriate question would have been whether the E&P was subject to taxation in the earlier year. On the other hand, because the statute only limits the use of losses and credits of other group members against the taxable income of the subsidiary and does not deny the dividends-received deduction, it does not prevent a subsidiary with no net income of its own from using accumulated E&P to make dividend distributions to minority shareholders.

124 IRC Section 1503(f)(2)(A). Thus, a subsidiary can use its *own* losses to offset such income. *See* H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 549 (1989). This prohibition on loss utilization differs from the Senate proposal, which would have disallowed the dividends-received deduction. For an analysis, *see* Schler, *Money Market Preferred Stock: Making the Punishment Fit the Crime*, 46 Tax Notes 935 (Feb. 19, 1990).

125 IRC Section 1503(f)(2)(B).

126 IRC Section 1503(f)(2).

127 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 550, *Ex. 1* (1989).

Example:

NOL carryover. The facts are the same as in the previous example, except that *S* also has a $100 NOL carryforward from a prior taxable year. In accordance with the operation of the normal ordering rules that current year losses are absorbed before loss carryforwards of a prior year, *P*'s loss offsets only $40 of *S*'s taxable income for the taxable year. However, $60 of *S*'s NOL carryforward may be used to offset the remainder of its own income for 1990. Thereafter, *S*'s remaining NOL carryforward is reduced by $60.[128]

Example:

Income of other members can be offset. *P* is the common parent of a consolidated group, and its wholly owned subsidiaries are *S1* and *S2*. *S1* issues applicable preferred stock. For the taxable year, *P* has a loss of $100, *S1* has taxable income of $100 and pays a dividend of $60 on the applicable preferred stock, and *S2* has income of $100. *P*'s loss may not offset the $60 of *S1*'s disqualified separately computed taxable income. However, the remaining taxable income of the group is $140. The group will pay no additional tax notwithstanding the application of *IRC Section 1503(f)* because *P*'s $100 loss will be offset against the remaining $140 of income.[129]

The Treasury is authorized to prescribe regulations as necessary or appropriate to carry out *IRC Section 1503(f)*.[130] The guidance is expected to include regulations (i) to prevent the avoidance of *IRC Section 1503(f)* through the contribution of built-in loss assets,[131] (ii) to include in the separately computed taxable income of any distributing corporation an allocable portion of the separately computed taxable income of any other member of the group whose stock the distributing corporation holds directly or indirectly,[132] (iii) to treat income that is not distributed in the current year as disqualified separately computed taxable income if all or any portion of dividends on the applicable preferred stock are not paid currently, including cases where this stock permits or requires deferred distributions, where the dividends paid currently are

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[128] *Id.* at 550–51, *Ex. 2.* Might the ordering rules be used in conjunction with IRC Section 1503(f) to actually improve loss absorption?

> **Example:** *P* and *S* are members of a consolidated group. *S* has a $100 SRLY NOL that will expire at the end of Year 1. The *P* group breaks even for Year 1, with *S*'s separate taxable income offsetting the deductions of other members. *S* distributes a $100 dividend on applicable preferred stock to minority shareholders, and none of *S*'s separately computed taxable income exceeds its disqualified separately computed income. Because none of *S*'s separate taxable income may be offset by a group loss or a group credit item, *S* may absorb its SRLY NOL carryover before it expires. In effect, *S*'s expiring SRLY NOL is effectively refreshed and converted into a new consolidated loss.

[129] *Id.* at 551, *Ex. 4.*

[130] IRC Section 1503(f)(4).

[131] IRC Section 1503(f)(4)(A). These regulations will prevent obvious planning techniques to eliminate the taxable income of a subsidiary without a corresponding effect on its current or accumulated E&P necessary for distributions on the preferred stock. The legislative history indicates that regulations "will prevent avoidance of the rules through the contribution of built-in loss assets or other direction of losses or credits to the subsidiary by other members of the group." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 549 (1989). Although the same result of eliminating the subsidiary's income can also be achieved by shifting its taxable income to other group members, there is no mention of this planning strategy.

[132] IRC Section 1503(f)(4)(B). These regulations would prevent the subsidiary from contributing its assets to a lower-tier subsidiary and arguing that it had no separate taxable income of its own. Although this effectively treats the subsidiary and its lower-tier subsidiary as a single entity, it does not appear to also provide that losses of the lower-tier subsidiary can be used by the issuing subsidiary to reduce its separate taxable income and thereby avoid the limitation of IRC Section 1503(f).

less than the yield to maturity of the stock, or where redemption or liquidation rights of this stock exceed the issue price paid for this stock,[133] (iv) to reflect the intent that losses or credits of other members of the group that may not be used against disqualified separately computed taxable income may be carried back or forward against income not affected by this provision;[134] and (v) in cases in which additional tax is paid for a taxable year as a result of this provision, to provide guidance on the effect of this additional tax on the E&P of the members of the group.[135] Query whether this regulatory authority could be considered self-executing, and therefore future regulations could apply to periods before their issuance?[136]

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133 IRC Section 1503(f)(4)(C).

134 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 550 (1989).

135 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 550 (1989).

136 Numerous cases have found the issuance of regulations not to be a condition precedent to the implementation of specific Code provisions. *See, e.g.*, Estate of Neumann v. Comm'r, 106 T.C. 216 (T.C. 1996) (distinguish between regulations that determine whether to adopt a rule, and regulations that chose which rules to adopt); H Enters. Int'l, Inc. v. Comm'r, 105 T.C. 71 (T.C. 1995) (single-entity treatment of the consolidated group for purposes of IRC Sections 246A and 265); H Enters. Int'l, Inc. v. Comm'r, 75 T.C.M. 1948 (1998) (finding of fact and conclusions of law), aff'd, 183 F.3d 907 (8th Cir. 1999), *reh'g denied* (8th Cir. Oct. 8, 1999); *First Chicago Corp. v. Comm'r*, 88 T.C. 663 (T.C. 1987), aff'd, 842 F.2d 180 (7th Cir. 1988); Occidental Petroleum Corp. v. Comm'r, 82 T.C. 819 (T.C. 1984). On the other hand, the Service has found regulatory authority to not be self-executing where the grant of authority does not provide sufficient guidance. *See, e.g.*, TAM 9714002 (Dec. 6, 1996) (a taxpayer could not avoid the disaffiliation of its subsidiary by arguing that regulatory authority under IRC Section 1504(a)(5)(F) was self-executing); ***PLR 9735002 (May 5, 1997)*** (because regulatory guidance has not been issued under IRC Section 7872(c)(1)(E) to define "significant effect" loans, a loan cannot presently be classified as subject to that provision).

§ 1.01 The Consolidated Return System in Brief

The consolidated return system began in 1917, only a few years after the adoption of the income tax system itself. Over the years, the consolidated return rules have evolved into a complex system. The first provisions for consolidation were anti-abuse provisions, designed to prevent the evasion of a surtax implemented by the government to fund the U.S. efforts in World War I. Even at that early stage, Congress was reluctant to adopt rules that would require examination of the numerous intercompany transactions that occurred among affiliated corporations.[1] Thus, the first rules prescribed by the Service, which generally treated a consolidated group as a single entity, emerged as the preferred method for solving the complex problems under the Code that resulted from related-party relationships.

The early consolidated return systems were undefined in many respects. The fundamental concepts of corporate income taxation, on which consolidation makes modifications, had not yet developed. Moreover, the U.S. system of taxation had no prior experience with consolidation; there was no clear model on which it was based, and no authoritative government guidance was provided for the numerous issues that quickly arose. Although concepts were borrowed from the principles of consolidated financial accounting, significant differences exist between the goals of financial accounting (to prevent the *overstatement* of profits) and the goals of income taxation (to prevent the *understatement* of taxable income).

The consolidated return provisions initially mandated that eligible corporations file consolidated returns. Once the World War I effort was funded, however, the system switched to elective filing, and it remains elective today. Despite numerous problems, consolidation was (and is) attractive to both taxpayers and the government. Taxpayers achieved flexibility in the organization of business activities, and the government was able to eliminate the effects of potentially suspicious related-party transactions. Consolidated return filing reflects "the principal of taxing as a business unit what is in reality a business unit."[2]

The basic purpose of the consolidated return system is to reduce the effect that the separate existence of affiliated corporations has on the aggregate tax liability of the group. The current rules treat the members of a consolidated group as a single entity for many purposes, but as separate entities for many other purposes.[2.1] This hybrid system of single and separate entity treatment represents a compromise that has evolved over time and has developed without significant attention to minimizing complexity.[2.2]

The ability to offset one member's losses against another member's income may be the single most important feature of filing on a consolidated basis.

Example 1:

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[1] *See, e.g.*, H.R. Rep. No. 704, 73d Cong., 2d Sess. 16–17 (1934) ("The administration of the income tax law is simpler with the consolidated return since it conforms to ordinary business practice; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions"). The current tax system requires arms' length pricing under *IRC Section 482*, prevents loss acceleration through *IRC Sections 267* and *269*, and has other special provisions for related-party activity. Initially, the tax system had none of these provisions, and consolidation was an early effort by the government to avoid these more complex systems.

[2] S. Rep. No. 617, 65th Cong., 3d Sess. 8–9 (1918). *See also* H.R. Rep. No. 749, 88th Cong., 1st Sess. 116 (1963); S. Rep. No. 830, 88th Cong., 2d Sess. 148 (1964).

[2.1] See *Ch. 22* for examples of this single versus separate entity distinction in computing consolidated taxable income.

[2.2] See, e.g., *§ 41.04[6][b]* for a discussion of the rules dealing with specified liability losses under *IRC Section 172(f)* in the consolidated context. For an excellent discussion of the separate entity and aggregate entity concepts, *see* Dubroff and Broadbent, *Consolidated Returns: Evolving Single and Separate Entity Themes*, 72 Taxes 743 (1994).

Loss sharing. *P* is the common parent of the *P* consolidated group, and *P* owns all of the only class of stock of subsidiaries *S* and *B*. The first step in determining consolidated taxable income or consolidated net operating loss is to compute the separate taxable income (or loss) of each member.[3] For Year 1, *P* earns $100, *S* earns $50 and *B* incurs a $125 loss. The separate taxable incomes and losses are then combined, with the effect that current year losses of members are offset against the current taxable income of other members. Thus, the *P* group's consolidated taxable income for Year 1 is $25 ($100, plus $50, minus $125).

A natural relationship exists between consolidation and the ability of taxpayers to otherwise carryover losses to other taxable years. If a risky venture is to be undertaken by a single taxpayer, it is desirable to have the ability to carryover losses from early years of the venture to later years, when profits are earned. If this carryover ability is limited, the single taxpayer must adapt by combining its risky venture with other more mature ventures that produce income so that the losses can be absorbed currently. Of course, this typically requires exposing the mature venture to the business risks of the risky venture.[4] Consolidated return filing is a natural vehicle to achieve the flexibility required by taxpayers to join risky and mature businesses without exposure to liability, because isolating business activities in separate members offers the group the insulation from liability traditionally associated with the corporate form of organization.[5]

The consolidated return regulations also provide special rules with regard to transactions between members of the consolidated group. The rules, for the most part, apply principles which treat such transactions as occurring between divisions of a single entity.[6]

Example 2:

Intercompany accounting. (a) *P*, the common parent of the *P* consolidated group, owns all of the only class of stock of subsidiaries *S* and *B*. *S* holds land with a basis of $70. On January 1 of Year 1, *S* sells the land to *B* for $100. *B* develops the land as residential real estate and sells developed lots to customers during Year 3 for an aggregate amount of $110. *S* must ultimately take into account its $30 gain ($100 proceeds minus $70 basis). But *S* 's $30 gain is not taken into account when recognized in Year 1. Instead, it is deferred and taken into account based on later events in order to treat *S* and *B* more like divisions of a single corporation. The sales by *B* to customers in Year 3 are the appropriate event for taking *S* 's gain into account. Thus *S* 's entire $30 (as well as *B* 's $10) gain is taken into account in Year 3.

(b) The facts are the same as in (a) above, except that on December 31 of Year 2, *P* sells 60 percent of *S* 's stock to *X* for $60 and *S* therefore becomes a nonmember. Although *S* 's $30 gain would otherwise be taken into account in Year 3, the entire gain is accelerated and taken into account in Year 2. Once *S* leaves the consolidated group, it is no longer possible to treat *S* and *B* as divisions of a single corporation.

In addition, the basis of the stock of a consolidated subsidiary is adjusted each year to take into account the earnings or losses of the subsidiary.[7] These rules are similar to those that apply to partnerships and S corporations.[8]

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[3] *See* Treas. Reg. §§ 1.1502-11(a)(1) (computation of consolidated taxable income) and 1.1502–21(e) (consolidated net operating loss).

[4] Other forms of organization also permit loss sharing while limiting liability. For example, the risky venture can be conducted through a limited partnership or other entity, such as an LLC, whose losses flow through to investors while at the same time insulating the investors from liability.

[5] Congress recognized that an integrated business activity may have to be broken down into separate corporations for a variety of nontax, business reasons. For example, railroads were required to maintain separate corporate structures in each state in which they operated, even though the separate corporations constituted a single operating system. *See* H.R. Rep. No. 704, 73d Cong., 2d Sess. 17 (1934).

[6] *Treas. Reg. § 1.1502-13*.

Example 3:

Investment adjustments. (a) *P*, the common parent of the *P* consolidated group, owns all of the only class of stock of subsidiary *S*. *P* has a $50 basis in the *S* stock. For Year 1, *S* has $100 of income. *S*'s income results in a $100 positive adjustment that increases *P*'s basis in *S*'s stock from $50 to $150.[9] Because the sale of a member's stock is not recharacterized as a sale of its assets, investment adjustments of this type are necessary to prevent *S*'s income from being taxed twice. If *S*'s $100 of income is assumed to increase the value of *S*'s stock by $100, and *P* sells the stock of *S* as a separate entity, the failure to provide for investment adjustments would result in *P* recognizing a $100 gain on the sale. The *P* group would therefore be taxed twice on the same income, once when earned by *S* and a second time when the *S* stock was sold.

(b) The facts are the same as in (a) above, except that *P* acquired the *S* stock by purchase for $100, and *S* had one asset with a $0 basis and $100 value at the time of *P*'s purchase of the *S* stock. *S* sells its appreciated asset for $100. *S*'s income results in a $100 positive adjustment that increases *P*'s basis in *S*'s stock from $100 to $200, even though the income was "built-in" at the time of *P*'s purchase and does not reflect an increase in the value of *S*. Thus, without special rules, this basis increase permits *P* to recognize a $100 loss on the sale of the *S* stock and effectively offset *S*'s income from sale of the asset. A special consolidated return rule denies *P*'s loss because it is attributable to *P*'s recognition of built-in gain.[10]

A consolidated federal income tax return is filed on the same form that is used by corporations that file on a separate basis (e.g., Form 1120, Form 1120L, etc.).[11] The first consolidated return of an affiliated group must include each subsidiary's consent (Form 1122) to the consolidated return regulations, which grants the necessary authorization to the common parent corporation to make the return on its behalf for the taxable year.[11.1] In addition, it is necessary to include with the first consolidated return and each consolidated return thereafter an Affiliations Schedule (Form 851), which lists pertinent identifying data for members of the group. The return must also include a statement of income and deductions, credits, as well as other required schedules, prepared in columnar form, so that the details of the items for each member may be readily audited. Similarly, the consolidated balance sheets and reconciliation of consolidated surplus, are to be prepared in columnar form for each corporation.[12] The return is to be filed with the Internal Revenue Service Center with whom the common parent would have filed a separate return.[13]

The consolidated return of an affiliated group relates only to its income tax liability, including its liability for any alternative minimum tax.[14] The return does not cover the liability of the members for applicable payroll or excise taxes; these taxes are computed and reported on the basis of separate return filings.

Many states do not permit affiliated corporations to file on a consolidated basis. This fact is particularly important with regard to intercompany transactions and reorganizations within the affiliated group.[14.1]

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[7] *Treas. Reg. § 1.1502-32*. *See* *Ch. 51*.

[8] *IRC Sections 705* and *1367*, respectively.

[9] Conversely, *P*'s basis in the *S* stock is generally reduced to the extent *S*'s losses are used to offset consolidated taxable income or expire.

[10] *Treas. Reg. § 1.337(d)-2*. *See* *Ch. 72*.

[11] Form 1120A cannot be used by corporations filing a consolidated return.

[11.1] *See* *Ch. 13* for a discussion on making the election to file a consolidated return.

[12] *Treas. Reg. § 1.1502-75(j)*.

[13] *Treas. Reg. § 1.1502-75(h)(1)*.

[14] *Treas. Reg. § 1.1502-2*.

End of Document

[14.1] Tax practitioners should be mindful of the state tax consequences of intercompany transactions. For example, many states have adopted the Internal Revenue Code, but either (1) do not permit affiliated corporations to file a consolidated return; or (2) do not follow the federal consolidated return regulations. Accordingly, the gain (or loss) that is deferred by *S* for federal income tax purposes in Example 2 of this Chapter may be required to be recognized immediately by some states.

Also, many affiliated groups enter into plans of reorganization either for internal business purposes or often times to reduce the affiliated group's combined state tax burden. These reorganizations may create unintended results for the unwary. For example, a brother-sister merger is generally treated as a "D" reorganization. If the merged entity had liabilities in excess of the tax basis in its assets, *IRC Section 357(c)* would require the merged entity to recognize gain to the extent of such excess if separate returns were filed. However, if the group elects to file a consolidated return, *Treas. Reg. § 1.1502-80(d)* overrides the application of *IRC Section 357(c)*. Accordingly, if the merged company operates in a state which follows the federal rules but not the consolidated return regulations, the gain under *IRC Section 357(c)* would be recognized immediately for state income tax purposes.