

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 9204, page 1279.

Final regulations under section 143 of the Code provide rules for calculating the effective rate of mortgage interest. Specifically, the regulations provide that amounts paid for pool mortgage insurance are to be excluded from the calculation of the effective rate of mortgage interest (which results in a lower effective rate of mortgage interest). Generally, interest on bonds issued by state and local governments is excluded from gross income. However, this exclusion does not apply to non-qualified private activity bonds. A qualified mortgage bond or a qualified veterans' mortgage bond (together, "qualified mortgage revenue bonds") may be a qualified bond. A bond may only be a qualified mortgage revenue bond if the effective rate of mortgage interest on the mortgages provided with the bond proceeds does not exceed the yield on the bonds by more than 1.125 percentage points.

T.D. 9205, page 1267.

REG-134030-04, page 1339.

Temporary and proposed regulations under section 41 of the Code provide rules for the computation and allocation of the credit for increasing research activities in the case of a controlled group of corporations or a group of trades or businesses under common control. The regulations also provide rules for making and revoking an election to compute the research credit using the alternative incremental research credit rules. A public hearing on the proposed regulations is scheduled for October 19, 2005. REG-133791-02 withdrawn.

T.D. 9206, page 1283.

REG-158138-04, page 1341.

Temporary and proposed regulations under section 6050L provide guidance for the filing of information returns by donees relating to qualified intellectual property contributions. The regulations affect donees receiving net income from qualified intellectual property contributions after June 3, 2004.

REG-168892-03, page 1293.

Proposed regulations under section 7702 of the Code define the attained age of the insured under contracts intending to qualify as life insurance contracts and explain how to use that age to test whether a contract qualifies as a life insurance contract for federal income tax purposes. A public hearing is scheduled for September 14, 2005.

REG-102144-04, page 1297.

Proposed regulations under section 1503(d) of the Code address various dual consolidated loss issues, including exceptions to the general prohibition against using a dual consolidated loss to reduce the taxable income of any other member of the affiliated group. Section 1503(d) generally provides that a dual consolidated loss of a dual resident corporation cannot reduce the taxable income of any other member of the affiliated group unless, to the extent provided in regulations, such loss does not offset the income of any foreign corporation. Similar rules apply to losses of separate units of domestic corporations. A public hearing is scheduled for September 7, 2005.

(Continued on the next page)

Finding Lists begin on page ii.



Notice 2005-44, page 1287.

Charitable contributions of qualified vehicles. This notice provides interim guidance under section 170(f)(12) of the Code regarding the deductibility of vehicle contributions. The notice explains the new requirements applicable to the acknowledgments that donee organizations provide to vehicle donors. In addition, the notice provides guidance on the new penalties section 6720 imposes on donee organizations that provide a false or fraudulent acknowledgment of a vehicle contribution, or fail to properly furnish the acknowledgment. Sections 170(f)(12) and 6720 are effective for vehicle contributions made after December 31, 2004.

ADMINISTRATIVE

T.D. 9203, page 1285.

Final regulations under section 7701 of the Code provide that an eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation.

T.D. 9206, page 1283.

REG-158138-04, page 1341.

Temporary and proposed regulations under section 6050L provide guidance for the filing of information returns by donees relating to qualified intellectual property contributions. The regulations affect donees receiving net income from qualified intellectual property contributions after June 3, 2004.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 41.—Credit for Increasing Research Activities

26 CFR 1.41–6T: Aggregation of expenditures (temporary).

T.D. 9205

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the computation and allocation of the credit for increasing research activities for members of a controlled group of corporations or a group of trades or businesses under common control. These temporary regulations reflect changes made to section 41 by the Revenue Reconciliation Act of 1989 (1989 Act), which introduced the current computational regime for the credit, and the Small Business Job Protection Act of 1996, which introduced the alternative incremental research credit. The text of the temporary regulations also serves as the text of the proposed regulations (REG–134030–04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective May 24, 2005.

Applicability Dates: For dates of applicability, see §§1.41–6T(j) and 1.41–8T(b)(5).

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino (202) 622–3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On July 29, 2003, the Treasury Department and the IRS published in the **Federal Register** (68 FR 44499) proposed amendments to the regulations under section 41(f) (REG–133791–02, 2003–2 C.B. 493) (the 2003 proposed regulations) relating to the computation and allocation of the credit for increasing research activities (research credit) under section 41 for members of a controlled group of corporations or a group of trades or businesses under common control (controlled groups). The 2003 proposed regulations withdrew the proposed regulations published in the **Federal Register** on January 4, 2000 (65 FR 258) (REG–105606–99, 2000–1 C.B. 421) (the 2000 proposed regulations). In general, the 2000 proposed regulations required controlled groups to compute a group credit and then to allocate that group credit among the members of the controlled group. The allocation of the group credit under the 2000 proposed regulations was based on the relative increases of each member’s qualified research expenses (QREs) over a base amount that was computed by multiplying that member’s most recent average annual gross receipts by the controlled group’s fixed-base percentage.

Although the 2003 proposed regulations did not modify the rules relating to the computation of the group credit, the 2003 proposed regulations did modify the rules relating to the allocation of the group credit among the members of the controlled group. In particular, the 2003 proposed regulations allocated the group credit in proportion to the credit, if any, that a member of a controlled group would be entitled to claim if it were not a member of a controlled group (the stand-alone entity credit). In addition, based on the comments to the 2000 proposed regulations, the 2003 proposed regulations did not propose special rules that would apply to consolidated groups that were members of a controlled group. A public hearing on the 2003 proposed regulations was held on November 13, 2003. After considering

the written comments and the statements at the public hearing, the Treasury Department and the IRS are withdrawing the 2003 proposed regulations and are issuing temporary regulations and proposed regulations cross-referencing the temporary regulations. In substantial part, the temporary regulations retain the rules contained in the 2003 proposed regulations with certain modifications discussed below.

Summary of Comments and Explanation of Provisions

Computation of the Group Credit

Section 41(f)(1)(A)(i) provides that “all members of the same controlled group of corporations shall be treated as a single taxpayer” in determining the amount of the research credit under section 41. Section 41(f)(1)(B)(i) provides a similar rule for a group of trades or businesses under common control. The 2003 proposed regulations applied the section 41 computational rules on an aggregate basis for purposes of determining the amount of the group credit. Additionally, a controlled group would have been treated as a start-up company for purposes of determining the group’s fixed-base percentage only if each member of the group qualified as a start-up company. Therefore, a controlled group with only two members would have been subject to the start-up rules if one member of the group had QREs but no gross receipts in 1983 and the other member had gross receipts but no QREs in 1983.

Commentators generally agreed with the proposed rules for computing the group credit. Commentators were concerned, however, with perceived ambiguities related to the application of the start-up company rules to a controlled group. For example, commentators asked that the regulations clarify what a controlled group’s start-up date is if all the members of the group are start-up companies with different start-up dates.

These temporary regulations retain the rules in the 2003 proposed regulations for the computation of the group credit, except for the start-up company rules. The temporary regulations state that a controlled group is treated as a start-up company for

purposes of computing the group credit if (A) the first taxable year in which at least one member of the group had gross receipts and at least one member of the group had QREs begins after December 31, 1983, or (B) there were fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which at least one member of the group had gross receipts and at least one member of the group had QREs. Consistent with this approach, the first taxable year in which a controlled group has gross receipts for purposes of the start-up company rules is the first year in which at least one member of the group has gross receipts. Likewise, the first taxable year in which a controlled group has QREs for purposes of the start-up company rules is the first year in which at least one member of the group has QREs. The Treasury Department and the IRS believe that this approach is more consistent with treating a controlled group as a single taxpayer because a controlled group with two members is not subject to the start-up rules if one member of the group had QREs but no gross receipts in 1983 and the other member had gross receipts but no QREs in 1983. Additionally, the temporary regulations specifically state that for purposes of determining the fixed-base percentage, the first taxable year after December 31, 1993, for which a controlled group has QREs is the first taxable year in which at least one member of the group has QREs.

Allocation of the Group Credit

Section 41(f)(1)(A)(ii) provides that “the [portion of the group] credit (if any) allowable by this section to each such member shall be its proportionate shares of the qualified research expenses and basic research payments giving rise to the credit.” Section 41(f)(1)(B)(ii) provides a similar rule for a group of trades or businesses under common control. The 2003 proposed regulations apply these provisions by allocating the group credit based on the relative amounts of each individual member’s stand-alone entity credit.

A number of commentators requested changes to the method of allocating the group credit contained in the 2003 proposed regulations. In general, these comments reflected dissatisfaction either with the stand-alone entity credit method in

the 2003 proposed regulations or with any single, prescribed method. Consequently, commentators either proposed specific alternatives or stated that final regulations should allow members to allocate the group credit using any reasonable method. One commentator advocated that a method that allocates the group credit based on the relative amounts of each member’s total QREs (gross QREs method) is the only allocation method permitted under the statute. Another commentator urged the Treasury Department and the IRS to adopt an allocation method that, based on techniques of differential calculus, allocates the group credit based on the marginal contribution to the group credit of each member’s QREs for the current year, QREs for the base years, and gross-receipts for the base years, as well as the controlled group’s fixed-base percentage and the growth in gross receipts for the controlled group (marginal contribution method). Other commentators suggested that no single allocation method can appropriately allocate the group credit in all cases; therefore, members of a controlled group should be permitted to use any reasonable method to allocate the group credit. For the reasons discussed below, these temporary regulations generally retain the stand-alone entity credit method of the 2003 proposed regulations with some modifications.

The preamble to the 2003 proposed regulations sets out at length the reasons why the Treasury Department and the IRS believe that the allocation method under section 41(f) should be based on a group member’s QREs in excess of a base amount. The stand-alone entity credit method reflects the incremental nature of the credit and also is consistent with the Treasury Department and the IRS’ view of the purpose of section 41(f). As stated in the preamble to the 2003 proposed regulations:

The legislative history to the research credit, as originally enacted in 1981, indicates that the group credit computation and aggregation rules were enacted to ensure that the research credit would be allowed only for actual increases in research expenditures. These aggregation rules were intended to prevent taxpayers from creating artificial increases in research expenditures by shifting expenditures among commonly

controlled or otherwise related persons. H. Rep. No. 97–201, 1981–3 C.B. (Vol. 2) 364, and Sen. Rep. 97–144, 1981–3 C.B. (Vol. 2) 442. In effect, the group credit computation rule serves as a cap on the maximum amount of credit that the members of the group, in the aggregate, may claim.

Prior to the 1989 Act, the research credit was computed by multiplying the credit rate by the excess of the taxpayer’s current year QREs over the taxpayer’s average QREs for the preceding three years. Final regulations issued in 1989, prescribing rules for the allocation of the group credit prior to the 1989 Act, allocated the group credit based on what effectively would have been each member’s stand-alone entity credit (without giving effect to the minimum base period amount in computing each member’s stand-alone entity credit). The 1989 Act significantly modified the computation of the credit while retaining the incremental approach of the pre-1989 Act credit. Congress did not indicate in either the statute or the legislative history that either the purpose or the application of section 41(f) was being changed. Although the phrase “increase in” in sections 41(f)(1)(A)(ii) and 41(f)(1)(B)(ii) was deleted by the 1989 Act, for the reasons set out in the preamble to the 2003 proposed regulations, the Treasury Department and the IRS concluded that this change to the statute was intended to reflect only the fact that a taxpayer’s entitlement to the research credit after the 1989 Act no longer depended on whether the taxpayer had increased its current year QREs over its average QREs for the preceding three years.

With respect to the alternative allocation methods suggested by the commentators, the Treasury Department and the IRS conclude that these methods are inconsistent with the purpose of section 41 generally and section 41(f) specifically. A gross QREs method is at odds fundamentally with the incremental nature of the research credit, and the Treasury Department and the IRS continue to believe that neither the statute nor the legislative history suggests that Congress intended that the allocation of the group credit be based solely on a member’s total QREs without reference to whether those QREs exceed a base amount.

Similarly, the Treasury Department and the IRS do not believe that the suggested marginal contribution method is consistent with section 41(f). The Treasury Department and the IRS recognize the potential for that method to more closely associate the amount of group credit allocated to a particular member to the contributions of that member's QREs for the current year, gross receipts for the current year, QREs for the base years, and gross receipts for the base years to the amount of the group credit. The marginal contribution method proposed, however, has significant flaws that would change the function of the aggregation rules in section 41(f) in a manner that the Treasury Department and the IRS do not believe was intended by Congress. First, the method would allow allocations of credit to members that have no QREs, a result the Treasury Department and the IRS believe is contrary to the statutory directive to allocate the group credit in proportion to a member's share of QREs giving rise to the credit. Second, the method uses different formulas for groups that are affected by special rules, such as the maximum fixed-base percentage rule. As a result, it is possible that a member of a group that increases its QREs by a relatively small amount, that is enough to make the group subject to a special rule, could be allocated proportionately less credit than if the member had not increased its QREs. Finally, by relying on the group's gross receipts and the group's fixed-base percentage, the marginal contribution method appears to encourage planning and shifting among group members, a result that is inconsistent with the purpose of section 41(f). The Treasury Department and the IRS believe that an appropriate allocation method should encourage a member to focus on incrementally increasing its own research efforts.

The Treasury Department and the IRS also decline to adopt an allocation rule that would permit the members of a controlled group to use any reasonable method to allocate the group credit. Neither the statute nor the legislative history indicates that Congress intended the allocation of the group credit to be based on any reasonable method selected by a member individually or the controlled group collectively. Furthermore, a rule permitting the use of any reasonable method to allocate the credit could result in continuing con-

troversy. As discussed in the preamble to the 2003 proposed regulations, the Treasury Department and the IRS believe that the purpose of section 41(f) is undermined if the members of a controlled group use different allocation methods to claim more than 100 percent of the group credit. The Treasury Department and the IRS believe that a single, prescribed method is necessary to preclude such potential for abuse.

Accordingly, the Treasury Department and the IRS continue to believe that the purposes of the research credit statute generally and the provisions of section 41(f) specifically are best furthered by an allocation method that allocates the group credit based on each member's stand-alone entity credit.

Special Allocation Rule For Excess Group Credit Situations

Under the 2003 proposed regulations, if the group credit exceeded the sum of the stand-alone entity credits of the members of a controlled group, the members with stand-alone entity credits would be entitled to the entire group credit. In addition, if no member of the controlled group had a stand-alone entity credit, none of the group credit would be allocated to the members of the controlled group.

To address these situations, these temporary regulations modify the allocation method of the 2003 proposed regulations in cases in which the group credit exceeds the sum of the members' stand-alone entity credits, including cases in which no member has a stand-alone entity credit. If the group credit exceeds the sum of the members' stand-alone entity credits, each member is allocated an amount of group credit equal to that member's stand-alone entity credit. The remaining, or excess, amount of group credit is then allocated among all the members of the controlled group based on the ratio of an individual member's QREs to the sum of all the members' QREs.

Computation of Stand-Alone Entity Credits

Commentators questioned whether members must use the same method, *i.e.*, the method described in section 41(a) (regular credit method) or the alternative incremental research credit (AIRC) method described in section 41(c)(4), in

computing the stand-alone entity credit as that used to compute the group credit. The Treasury Department and the IRS do not believe that requiring taxpayers to be consistent in the method used to compute the group credit and the stand-alone entity credit would serve the purpose of section 41. Section 41(f) was intended to encourage taxpayers to increase their individual research efforts to maximize the group credit and thus their share of the group credit. The Treasury Department and the IRS believe that allowing the members to compute their stand-alone entity credits without regard to the method used to compute the group credit will encourage increasing research efforts. Thus, the temporary regulations provide that a member's stand-alone entity credit must be computed using whichever method results in the greater stand-alone entity credit for that member, without regard to the method used to compute the group credit.

Commentators also pointed out that the computation of the stand-alone entity credits under the 2003 proposed regulations would no longer require the intra-group transaction rules of §1.41-6(e) (re-designated in these temporary regulations as §1.41-6(i)) to apply. Although the intent of the stand-alone entity credit rule is to compute a credit that is similar to that to which a member would be entitled if there were no research credit aggregation rules for controlled groups, the intent was not to render the intra-group transaction rules or the acquisition/disposition rules of section 41(f)(3) inapplicable. Therefore, these temporary regulations specifically provide that taxpayers must apply the intra-group transaction rules and the acquisition/disposition rules when computing the stand-alone entity credits. For example, to the extent that a member's gross receipts and QREs have been reduced for purposes of computing the group credit as a result of the application of the acquisition/disposition rules, the member's stand-alone entity credit must be computed using the same gross receipts and QREs.

Special Allocation Rule for Consolidated Groups

The preamble to the 2003 proposed regulations states that the Treasury Department and the IRS considered com-

ments requesting a special allocation rule for consolidated groups, but decided not to adopt such a rule. Several commentators further commented on that issue. One commentator suggested that if the group credit were allocated in proportion to QREs, no special consolidated group rule would be necessary. Given that this commentator's proposed allocation method is not the one adopted in these temporary regulations, the Treasury Department and the IRS are not persuaded that a special consolidated group rule is unnecessary. Another commentator suggested that a consolidated group should be treated as a single member of a controlled group for purposes of allocating the group credit and that the failure to treat the consolidated group in such a manner would result in abuse.

The Treasury Department and the IRS believe that treating a consolidated group as a single member of a controlled group for purposes of allocating the group credit is consistent with the treatment of a consolidated group as a single taxpayer under a number of the consolidated return regulations. Therefore, these temporary regulations provide that, for purposes of allocating the group credit, a consolidated group whose members are members of a controlled group is treated as a single member of the controlled group. Accordingly, a consolidated group whose members are members of a controlled group is treated as a single member of the controlled group and a single stand-alone entity credit is computed for the consolidated group. If the consolidated group is the only member of the controlled group, the stand-alone entity credit computed for the consolidated group is equal to the group credit.

The portion of the group credit allocated to a consolidated group must be allocated among the members of the consolidated group. The Treasury Department and the IRS believe that the method of allocating among the members of the consolidated group the portion of the group credit allocated to the consolidated group should be no different than the method of allocating the group credit among members of the controlled group. Therefore, a stand-alone entity credit is computed for each member of the consolidated group, and the portion of the group credit allocated to the consolidated group is allocated among the members of the consolidated group in pro-

portion to the stand-alone entity credits of the members of the consolidated group. One commentator argued that separately computing the stand-alone credit for each member of a consolidated group would be prohibitively burdensome. The Treasury Department and the IRS, however, do not believe that computing a stand-alone entity credit for each member of a consolidated group imposes a greater burden than computing a stand-alone entity credit for a corporation that is not a member of a consolidated group. Moreover, providing a rule for allocating the portion of the group credit allocated to a consolidated group among its members that is different than the method used for allocating the controlled group credit would create additional administrative complexity that seems unwarranted.

Alternative Incremental Research Credit

Section 41(c)(4) provides an election to determine the research credit using the AIRC computation. Section 41(c)(4)(B) provides that the election to use the AIRC applies to all succeeding taxable years unless revoked with the consent of the Secretary. Many issues have arisen regarding how the AIRC election is made in the case of a consolidated group and in the case of a controlled group, all members of which are not included on a single consolidated federal income tax return. These issues include: (1) how is an AIRC election made by members of a controlled group for purposes of computing the group credit under section 41(f)(1); (2) what happens when a controlled group has made an AIRC election and a member leaves the group or a member that has not made an AIRC election enters the group; (3) what happens if a member that has made an AIRC election joins a controlled group that has not made an AIRC election; and (4) when will a request to revoke an AIRC election be granted.

Generally, the Treasury Department and the IRS assume that taxpayers will elect to use the AIRC method if the AIRC method provides more credit than the regular method, or if a taxpayer does not have the books and records necessary to compute the base amount under the regular method. Once a taxpayer elects the AIRC method, the Treasury Department and the IRS believe that the AIRC method

will continue to be the better method in the future as well, unless the taxpayer has a substantial change in its trade or business, such as the acquisition or disposition of an entire trade or business. If such a substantial change occurs, the Treasury Department and the IRS believe that it is appropriate to allow the taxpayer to revoke its AIRC election. The IRS has received many requests for consent to revoke AIRC elections from taxpayers in such situations. To reduce the burden on taxpayers, provide simplification, and ease administrative burden, the Treasury Department and the IRS have determined that it is appropriate to grant automatic consent to revoke an AIRC election on a prospective basis in situations in which a taxpayer makes the revocation on an original return. The Treasury Department and the IRS do not believe, however, that allowing an AIRC election or revocation on an amended return furthers the goal of simplification and ease of administration.

Therefore, these temporary regulations provide that a taxpayer that has made an AIRC election is deemed to have requested and been granted consent to revoke the election if the taxpayer completes the portion of Form 6765, "*Credit for Increasing Research Activities*," relating to the regular credit and attaches the completed form to the taxpayer's timely filed original return for the year to which the revocation applies. This provision is similar to the provisions in the existing regulations for making an AIRC election, which require the taxpayer to complete the portion of Form 6765 relating to the AIRC and attach the completed form to the taxpayer's timely filed original return for the year to which the election applies. Once an election/revocation is made for a taxable year, the taxpayer may not change the election/revocation on an amended return.

The temporary regulations provide special rules for controlled groups under section 41(f)(1) (in which one or more of the members do not join in filing a consolidated return). As discussed above, in this situation many questions have arisen regarding which members of a controlled group must make (or revoke) an AIRC election to have a valid election (or revocation) for the controlled group. Attempting to track elections across members of a controlled group, in which one or more of the members do not join in filing a consol-

idated return would create additional administrative complexity and increase the potential for controversy. Thus, to reduce the additional administrative complexity created by the additional computation, these temporary regulations provide that in the case of a controlled group, all the members of which are not included on a single consolidated return, the designated member must make (or revoke) an AIRC election on behalf of the members of the group. The election (or revocation) by the designated member is binding on all of the members of the group for the taxable year to which the election (or revocation) relates. The temporary regulations provide that the *designated member* is that member of the group that is allocated the greatest amount of the group credit. In the event the members of a group compute the group credit using different methods (either the regular method or the AIRC method) and at least two members of the group qualify as the *designated member*, the designated member is the member that computes the group credit using the method that yields the greater group credit. The Treasury Department and the IRS believe that these rules will simplify the election and revocation of the AIRC method. Furthermore, granting automatic consent to revoke an AIRC election also simplifies acquisitions and dispositions of members of controlled groups. For example, when a new member joins a group, the member must use the method used by the controlled group. In the taxable year after a member leaves a group, the member is free to use either method, assuming the member has not joined another controlled group. If all members of a controlled group are members of a single consolidated group, the AIRC election is made by the agent of the consolidated group, determined pursuant to the rules of § 1.1502-77.

Effective Date

The preamble to the 2003 proposed regulations stated that the Treasury Department and the IRS intended to make those regulations effective for taxable years beginning on or after the date that final regulations are published in the **Federal Register**. The preamble to the 2003 proposed regulations also addressed the limited application of final regulations to taxable years prior to that effective date

to prevent abuse. Because the Treasury Department and the IRS have decided to retain the general rules for the computation and allocation of the group credit contained in the 2003 proposed regulations, with the modifications described above, these regulations are being issued in temporary form and will be effective for taxable years ending on or after May 24, 2005.

For taxable years prior to those covered by these temporary regulations, a taxpayer generally may use any reasonable method of computing and allocating the group credit. For the reasons set out in the preamble to the 2003 proposed regulations, the Treasury Department and the IRS believe that these temporary regulations should be retroactive in limited circumstances to prevent abuse. Accordingly, paragraph (b) of these temporary regulations, relating to the computation of the group credit, and paragraph (c) of these temporary regulations, relating to the allocation of the group credit, apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group are deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

Since the issuance of the 2003 proposed regulations, questions have arisen regarding what constitutes a reasonable method of allocating the group credit. Any allocation method used by a member of a controlled group that is consistent with either the 2000 proposed regulations, the 2003 proposed regulations, these temporary regulations, or subsequent final regulations will be accepted by the IRS as reasonable if the same allocation method was used by all members of the controlled group. In addition, for taxable years ending before December 29, 1999, any such method will be accepted by the IRS as reasonable regardless of the allocation method or methods used by other members of the controlled group and regardless of whether the members of the controlled group, in the aggregate, claimed more than 100 percent of the group credit. Although the reasonableness

of any other allocation method may depend on the particular facts and circumstances of that taxpayer, in general, the IRS, solely for purposes of what constitutes a reasonable method of allocating the group credit for taxable years ending before December 29, 1999, will treat as reasonable a gross QREs method even if the members of the controlled group use inconsistent allocation methods to claim, in the aggregate, more than 100 percent of the group credit. Such treatment of a gross QREs method as reasonable for such years is for administrative convenience only.

Special Analyses

It has been determined that this Treasury Department decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of the proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Nicole R. Cimino, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.41-6T also issued under 26 U.S.C. 1502. * * *

Par. 2. In §1.41-0, the table of contents is amended by removing the entries for §1.41-6 and §1.41-8 and adding entries for §1.41-6T and §1.41-8T to read as follows:

§1.41-0 Table of contents.

* * * * *

§1.41-6T Aggregation of expenditures (temporary).

(a) Controlled groups of corporations; trades or businesses under common control.

- (1) In general.
 - (2) Consolidated groups.
 - (3) Definitions.
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- (1) In general.
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- (d) Special rules for consolidated groups.
- (1) In general.
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- (h) Membership during taxable year in more than one group.
- (i) Intra-group transactions.
 - (1) In general.
 - (2) In-house research expenses.
 - (3) Contract research expenses.
 - (4) Lease payments.
 - (5) Payment for supplies.
 - (j) Effective date.

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§1.41-8T Special rules for taxable years ending on or after January 3, 2001 (temporary).

- (a) Alternative incremental credit.

- (b) Election.
 - (1) In general.
 - (2) Time and manner of election.
 - (3) Revocation.
 - (4) Special rules for controlled groups.
 - (5) Effective date.

§1.41-6 [Removed]

Par. 3. Section 1.41-6 is removed.

Par. 4. Section 1.41-6T is added to read as follows:

§1.41-6T Aggregation of expenditures (temporary).

(a) *Controlled group of corporations; trades or businesses under common control*—(1) *In general*. To determine the amount of research credit (if any) allowable to a trade or business that at the end of its taxable year is a member of a controlled group, a taxpayer must—

(i) Compute the group credit in the manner described in paragraph (b) of this section; and

(ii) Allocate the group credit among the members of the group in the manner described in paragraph (c) of this section.

(2) *Consolidated groups*. For special rules relating to consolidated groups, see paragraph (d) of this section.

(3) *Definitions*. For purposes of this section:

(i) *Trade or business*. A trade or business is a sole proprietorship, a partnership, a trust, an estate, or a corporation that is carrying on a trade or business (within the meaning of section 162). Any member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(ii) *Controlled group*. The terms *group* and *controlled group* mean a controlled group of corporations, as defined in section 41(f)(5), or a group of trades or businesses under common control. For rules for determining whether trades or businesses are under common control, see §1.52-1(b) through (g).

(iii) *Group credit*. The term *group credit* means the research credit (if any) allowable to a controlled group.

(iv) *Consolidated group*. The term *consolidated group* has the meaning set forth in §1.1502-1(h).

(v) *Credit year*. The term *credit year* means the taxable year for which the member is computing the credit.

(b) *Computation of the group credit*—(1) *In general*. All members of a controlled group are treated as a single taxpayer for purposes of computing the research credit. The group credit is computed by applying all of the section 41 computational rules on an aggregate basis. All members of a controlled group must use the same method of computation, either the method described in section 41(a) or the alternative incremental research credit (AIRC) method described in section 41(c)(4), in computing the group credit for a credit year.

(2) *Start-up companies*—(i) *In general*. For purposes of computing the group credit, a controlled group is treated as a start-up company for purposes of section 41(c)(3)(B)(i) if—

(A) The first taxable year in which at least one member of the group had gross receipts and at least one member of the group had qualified research expenditures (QREs) begins after December 31, 1983; or

(B) There were fewer than 3 taxable years beginning after December 31, 1983, and before January 1, 1989, in which at least one member of the group had gross receipts and at least one member of the group had QREs.

(ii) *Example*. The following example illustrates the principles of paragraph (b)(2)(i) of this section:

Example. A, B, and C, all of which are calendar year taxpayers, are members of a controlled group. During the 1983 taxable year, A had QREs, but no gross receipts; B had gross receipts, but no QREs; and C had no QREs or gross receipts. The 1984 taxable year was the first taxable year for which each of A, B, and C had both QREs and gross receipts. Because the first taxable year for which each of A, B, and C had both QREs and gross receipts began after December 31, 1983, each of A, B, and C is a start-up company under section 41(c)(3)(B)(i) and each is a start-up company for purposes of computing the stand-alone entity credit. During the 1983 taxable year, at least one member of the group, A, had QREs and at least one member of the group, B, had gross receipts, thus, the group had both QREs and gross receipts in 1983. Therefore, the controlled group is not a start-up company because the first taxable year for which the group had both QREs and gross receipts did not begin after December 31, 1983.

(iii) *First taxable year after December 31, 1993, for which the controlled group had QREs*. In the case of a controlled group that is treated as a start-up company

under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section, for purposes of determining the group's fixed-base percentage under section 41(c)(3)(B)(ii), the first taxable year after December 31, 1993, for which the group has QREs is the first taxable year in which at least one member of the group has QREs.

(iv) *Example.* The following example illustrates the principles of paragraph (b)(2)(iii) of this section:

Example. D, E, and F, all of which are calendar year taxpayers, are members of a controlled group. The group is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section. The first taxable year after December 31, 1993,

for which D had QREs was 1994. The first taxable year after December 31, 1993, for which E had QREs was 1995. The first taxable year after December 31, 1993, for which F had QREs was 1996. Because the 1994 taxable year was the first taxable year after December 31, 1993, for which at least one member of the group, D, had QREs, for purposes of determining the group's fixed-based percentage under section 41(c)(3)(B)(ii), the 1994 taxable year was the first taxable year after December 31, 1993, for which the group had QREs.

(c) *Allocation of the group credit*—(1) *In general.* (i) To the extent the group credit (if any) computed under paragraph (b) of this section does not exceed the sum of the stand-alone entity credits of all of the members of a controlled group, computed

under paragraph (c)(2) of this section, such group credit shall be allocated among the members of the controlled group in proportion to the stand-alone entity credits of the members of the controlled group, computed under paragraph (c)(2) of this section:

$$\text{group credit that does not exceed sum of all the members' stand-alone entity credits} \times \frac{\text{member's stand-alone entity credit}}{\text{sum of all the members' stand-alone entity credits.}}$$

(ii) To the extent that the group credit (if any) computed under paragraph (b) of this section exceeds the sum of the stand-alone entity credits of all of the members of the controlled group, computed under paragraph (c)(2) of this section, such excess shall be allocated among the members of a controlled group in proportion to the QREs of the members of the controlled group:

$$(\text{group credit} - \text{sum of all the members' stand-alone entity credits}) \times \frac{\text{member's QREs}}{\text{sum of all the members' QREs.}}$$

(2) *Stand-alone entity credit.* The term *stand-alone entity credit* means the research credit (if any) that would be allowable to a member of a controlled group if the credit were computed as if section 41(f)(1) did not apply, except that the member must apply the rules provided in paragraphs (d)(1) (relating to consolidated groups) and (i) (relating to intra-group transactions) of this section. Each member's stand-alone entity credit for any credit year must be computed under whichever method (the method described in section 41(a) or the method described in section 41(c)(4)) results in the greater stand-alone entity credit for that member, without regard to the method used to compute the group credit.

(d) *Special rules for consolidated groups*—(1) *In general.* For purposes

of applying paragraph (c) of this section, a consolidated group whose members are members of a controlled group is treated as a single member of the controlled group and a single stand-alone entity credit is computed for the consolidated group.

(2) *Start-up company status.* A consolidated group's status as a start-up company and the first taxable year after December 31, 1993, for which a consolidated group has QREs are determined in accordance with the principles of paragraph (b)(2) of this section.

(3) *Special rule for allocation of group credit among consolidated group members.* The portion of the group credit that is allocated to a consolidated group is allocated to the members of the consolidated group in accordance with the principles of paragraph (c) of this section.

However, for this purpose, the stand-alone entity credit of a member of a consolidated group is computed without regard to section 41(f)(1), but with regard to paragraph (i) of this section.

(e) *Examples.* The following examples illustrate the provisions of this section. Unless otherwise stated, no members of a controlled group are members of a consolidated group, and except as provided in *Example 6*, the group has not made an AIRC election:

Example 1. Group credit is less than sum of members' stand-alone entity credits—(i) *Facts.* A, B, and C, all of which are calendar-year taxpayers, are members of a controlled group. Neither A, B, nor C made any basic research payments for their taxable year ending December 31, 2004. For purposes of computing the group credit for the 2004 taxable year (the credit year), A, B, and C had the following:

	A	B	C	Group Aggregate
Credit Year QREs	\$200x	\$20x	\$110x	\$330x
1984–1988 QREs	\$40x	\$10x	\$100x	\$150x
1984–1988 Gross Receipts	\$1,000x	\$350x	\$150x	\$1,500x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	\$1,200x	\$200x	\$300x	\$1,700x

(ii) *Computation of the group credit—(A) In general.* The research credit allowable to the group is computed as if A, B, and C were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs (\$330x) over the group's base amount (\$170x). The group credit is $0.20 \times (\$330x - \$170x)$, which equals \$32x.

(B) *Group's base amount—(1) Computation.* The group's base amount equals the greater of: the group's fixed-base percentage (10 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year (\$1,700x), or the group's minimum base amount (\$165x). The group's base amount, therefore, is \$170x, which is the greater of: $0.10 \times \$1,700x$, which equals \$170x, or \$165x.

(2) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is $0.50 \times \$330x$, which equals \$165x.

(3) *Group's fixed-base percentage.* The group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bear to the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 10 percent, which is the lesser of: $\$150x/\$1,500x$, which equals 10 percent, or 16 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, each member's stand-alone entity credit must be computed using the method that results in the greater stand-alone entity

credit for that member. The stand-alone entity credit for each of A, B, and C is greater using the method described in section 41(a). Therefore, the stand-alone entity credit for each of A, B, and C must be computed using the method described in section 41(a). A's stand-alone entity credit is \$20x. B's stand-alone entity credit is \$2x. C's stand-alone entity credit is \$11x. The sum of the members' stand-alone entity credits is \$33x. Because the group credit of \$32x is less than the sum of the stand-alone entity credits of all the members of the group (\$33x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The \$32x group credit is allocated as follows:

	A	B	C	Total
Stand-Alone Entity Credit	\$20x	\$2x	\$11x	\$33x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/33	2/33	11/33	
Multiplied by: Group Credit	\$32x	\$32x	\$32x	
Equals: Credit Allocated to Member	\$19.39x	\$1.94x	\$10.67x	\$32x

Example 2. Group credit exceeds sum of members' stand-alone entity credits—(i) Facts. D, E, F, and G, all of which are calendar-year taxpayers, are

members of a controlled group. Neither D, E, F, nor G made any basic research payments for their taxable year ending December 31, 2004. For purposes

of computing the group credit for the 2004 taxable year (the credit year), D, E, F, and G had the following:

	D	E	F	G	Group Aggregate
Credit Year QREs	\$580x	\$10x	\$70x	\$15x	\$675x
1984–1988 QREs	\$500x	\$25x	\$100x	\$25x	\$650x
1984–1988 Gross Receipts	\$4,000x	\$5,000x	\$2,000x	\$10,000x	\$21,000x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	\$5,000x	\$5,000x	\$2,000x	\$5,000x	\$17,000x

(ii) *Computation of the group credit—(A) In general.* The research credit allowable to the group is computed as if D, E, F, and G were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs (\$675x) over the group's base amount (\$526.19x). The group credit is $0.20 \times (\$675x - \$526.19x)$, which equals \$29.76x.

(B) *Group's base amount—(1) Computation.* The group's base amount equals the greater of: the group's fixed-base percentage (3.10 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year (\$17,000x), or the group's minimum

base amount (\$337.50x). The group's base amount, therefore, is \$526.19x, which is the greater of: $0.031 \times \$17,000x$, which equals \$526.19x, or \$337.50x.

(2) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is $0.50 \times \$675x$, which equals \$337.50x.

(3) *Group's fixed-base percentage.* The group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bear to the group's aggregate gross receipts for the same period, or 16 percent (the statu-

tory maximum). The group's fixed-base percentage, therefore, is 3.10 percent, which is the lesser of: $\$650x/\$21,000x$, which equals 3.10 percent, or 16 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, each member's stand-alone entity credit must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credits for D (\$19.46x) and F (\$1.71x) are greater using the AIRC method. Therefore, the stand-alone entity credits for D and F must be computed using the AIRC method. The stand-alone entity credit for

G (\$0.50x) is greater using the method described in section 41(a). Therefore, the stand-alone entity credit for G must be computed using the method described in section 41(a). E's stand-alone entity credit computed under either method is zero. The sum of the members' stand-alone entity credits is \$21.67x.

Because the group credit of \$29.76x is greater than the sum of the stand-alone entity credits of all the members of the group (\$21.67x), each member of the group is allocated an amount of the group credit equal to that member's stand-alone entity credit. The excess of the group credit over the sum of the mem-

bers' stand alone entity credits (\$8.09x) is allocated among the members of the group based on the ratio that each member's QREs bear to the sum of the QREs of all the members of the group. The \$29.76x group credit is allocated as follows:

	D	E	F	G	Total
Group Credit					\$29.76x
Minus: Sum of Stand-Alone Entity Credits	\$19.46x	\$0.00x	\$1.71x	\$0.50x	\$21.67x
Equals: Excess Group Credit					\$8.09x
Excess Group Credit	\$8.09x	\$8.09x	\$8.09x	\$8.09x	
Multiplied By Allocation Ratio: QREs/Sum of QREs	580/675	10/675	70/675	15/675	
Excess Group Credit Allocated	\$6.95x	\$0.12x	\$0.84x	\$0.18x	
Plus: Stand-Alone Entity Credit	\$19.46x	\$0.00x	\$1.71x	\$0.50x	
Equals: Credit Allocated to Member	\$26.41x	\$0.12x	\$2.55x	\$0.68x	\$29.76x

Example 3. Consolidated group within a controlled group—(i) Facts. The facts are the same as in *Example 2*, except that D and E file a consolidated return.

(ii) *Allocation of the group credit—(A) In general.* For purposes of allocating the controlled group's research credit of \$29.76x among the members of the controlled group, D and E are treated as a single member of the controlled group.

(B) *Computation of stand-alone entity credits.* The stand-alone entity credit for the consolidated group is computed by treating D and E as a single entity. Under paragraph (c)(2) of this section, the stand-alone entity credit for each member must be

computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for each of the DE consolidated group (\$17.55x) and F (\$1.71x) is greater using the AIRC method. Therefore, the stand-alone entity credit for each of the DE consolidated group and F must be computed using the AIRC method. The stand-alone entity credit for G (\$0.50x) is greater using the method described in section 41(a). Therefore, the stand-alone entity credit for G must be computed using the method described in section 41(a). The sum of the members' stand-alone entity credits is \$19.76x.

(C) *Allocation of controlled group credit.* Because the group credit of \$29.76x is greater than the sum of the stand-alone entity credits of all the members of the group (\$19.76x), each member of the group is allocated an amount of the group credit equal to that member's stand-alone entity credit. The excess of the group credit over the sum of the members' stand-alone entity credits (\$10.00x) is allocated among the members of the group based on the ratio that each member's QREs bear to the sum of the QREs of all the members of the group. The group credit of \$29.76x is allocated as follows:

	DE	F	G	Total
Group Credit				\$29.76x
Minus: Sum of Stand-Alone Entity Credits	\$17.55x	\$1.71x	\$0.50x	\$19.76x
Equals: Excess Group Credit				\$10.00x
Excess Group Credit	\$10.00x	\$10.00x	\$10.00x	
Multiplied By Allocation Ratio: QREs/Sum of QREs	590/675	70/675	15/675	
Excess Group Credit Allocated	\$8.74x	\$1.04x	\$0.22x	
Plus: Stand-Alone Entity Credit	\$17.55x	\$1.71x	\$0.50x	
Equals: Credit Allocated to Member	\$26.29x	\$2.75x	\$0.72x	\$29.76x

(iii) *Allocation of the group credit allocated to consolidated group—(A) In general.* The group credit that is allocated to a consolidated group is allocated among the members of the consolidated group in accordance with the principles of paragraph (c) of this section.

(B) *Computation of stand-alone entity credits.* Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the consolidated group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit

for D (\$19.46x) is greater using the AIRC method. Therefore, the stand-alone entity credit for D must be computed using the AIRC method. The stand-alone entity credit for E is zero under either method. The sum of the stand-alone entity credits of the members of the consolidated group is \$19.46x.

(C) *Allocation among members of consolidated group.* Because the amount of the group credit allocated to the consolidated group (\$26.29x) is greater than \$19.46x, the sum of the stand-alone entity credits of all the members of the consolidated group, the amount of the group credit allocated to the consoli-

dated group is allocated to each member of the consolidated group in an amount equal to the member's stand-alone entity credit. The excess of the group credit allocated to the consolidated group over the sum of the consolidated group members' stand alone entity credits (\$6.83x) is allocated among the members of the consolidated group based on the ratio that each member's QREs bear to the sum of the QREs of all the members of the consolidated group. The group credit of \$26.29x allocated to the DE consolidated group is allocated between D and E as follows:

	D	E	Total
Group Credit			\$26.29x
Minus: Sum of Stand-Alone Entity Credits	\$19.46x	\$0.00x	\$19.46x
Excess Group Credit			\$6.83x
Excess Group Credit	\$6.83x	\$6.83x	
Multiplied By Allocation Ratio: QREs/Sum of QREs	580/590	10/590	
Excess Group Credit Allocated	\$6.71x	\$0.12x	
Plus: Stand-Alone Entity Credit	\$19.46x	\$0.00x	
Equals: Credit Allocated to Member	\$26.17x	\$0.12x	\$26.29x

Example 4. Member is a start-up company—(i) Facts. H, I, and J, all of which are calendar-year taxpayers, are members of a controlled group. The first taxable year for which J has both QREs and gross receipts begins after December 31, 1983, therefore, J is

a start-up company under section 41(c)(3)(B)(i). The first taxable year for which H and I had both QREs and gross receipts began before December 31, 1983, therefore, H and I are not start-up companies under section 41(c)(3)(B)(i). Neither H, I, nor J made any

basic research payments during the 2004 taxable year. For purposes of computing the group credit for the 2004 taxable year (the credit year), H, I, and J had the following:

	H	I	J	Group Aggregate
Credit Year QREs	\$200x	\$20x	\$50x	\$270x
1984–1988 QREs	\$55x	\$15x	\$0x	\$70x
1984–1988 Gross Receipts	\$1,000x	\$400x	\$0x	\$1,400x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	\$1,200x	\$200x	\$0x	\$1,400x

(ii) *Computation of the group credit—(A) In general.* The research credit allowable to the group is computed as if H, I, and J were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs (\$270x) over the group's base amount (\$135x). The group credit is $0.20 \times (\$270x - \$135x)$, which equals \$27x.

(B) *Group's base amount—(1) Computation.* The group's base amount equals the greater of: the group's fixed-base percentage (5 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year (\$1,400x), or the group's minimum base amount (\$135x). The group's base amount, therefore, is \$135x, which is the greater of: $0.05 \times \$1,400x$, which equals \$70x, or \$135x.

(2) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's

aggregate credit year QREs. The group's minimum base amount is $0.50 \times \$270x$, which equals \$135x.

(3) *Group's fixed-base percentage.* Because the first taxable year in which at least one member of the group has QREs and at least one member of the group has gross receipts does not begin after December 31, 1983, the group is not a start-up company. Therefore, the group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bear to the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 5 percent, which is the lesser of: $\$70x/\$1,400x$, which equals 5 percent, or 16 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, the stand-alone entity

credit for each member of the group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credits for H (\$20x), I (\$2x), and J (\$5x) are greater using the method described in section 41(a). Therefore, the stand-alone entity credits for each of H, I, and J must be computed using the method described in section 41(a). The sum of the stand-alone entity credits of the members of the group is \$27x. Because the group credit of \$27x is equal to the sum of the stand-alone entity credits of all the members of the group (\$27x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The group credit of \$27x is allocated as follows:

	H	I	J	Total
Stand-Alone Entity Credit	\$20x	\$2x	\$5x	\$27x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/27	2/27	5/27	
Multiplied by: Group Credit	\$27x	\$27x	\$27x	
Equals: Credit Allocated to Member	\$20x	\$2x	\$5x	\$27x

Example 5. Group is a start-up company—(i) Facts. K, L, and M, all of which are calendar-year taxpayers, are members of a controlled group. The taxable year ending on December 31, 1999, is the

first taxable year in which each of K, L, and M had both QREs and gross receipts. Therefore, the taxable year ending on December 31, 1999, is the first taxable year in which at least one member of the group had

QREs and at least one member of the group had gross receipts. The 2004 taxable year is the fifth taxable year beginning after December 31, 1993, for which at least one member of the group had QREs. Neither

K, L, nor M made any basic research payments during the 2004 taxable year. For purposes of computing

the group credit for the 2004 taxable year (the credit year), K, L, and M had the following:

	K	L	M	Group Aggregate
Credit Year QREs	\$255x	\$25x	\$100x	\$380x
1984–1988 QREs	\$0x	\$0x	\$0x	\$0x
1984–1988 Gross Receipts	\$0x	\$0x	\$0x	\$0x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	\$1,600x	\$340x	\$300x	\$2,240x

(ii) *Computation of the group credit—(A) In general.* The research credit allowable to the group is computed as if K, L, and M were one taxpayer. The group credit is equal to 20 percent of the excess of the group’s aggregate credit year QREs (\$380x) over the group’s base amount (\$190x). The group credit is $0.20 \times (\$380x - \$190x)$, which equals \$38x.

(B) *Group’s base amount—(1) Computation.* The group’s base amount equals the greater of: the group’s fixed-base percentage (3 percent) multiplied by the group’s aggregate average annual gross receipts for the 4 taxable years preceding the credit year (\$2,240x), or the group’s minimum base amount (\$190x). The group’s base amount, therefore, is \$190x, which is the greater of: $0.03 \times \$2,240x$, which equals \$67.20x, or \$190x.

(2) *Group’s minimum base amount.* The group’s minimum base amount is 50 percent of the group’s aggregate credit year QREs. The group’s minimum base amount is $0.50 \times \$380x$, which equals \$190x.

(3) *Group’s fixed-base percentage.* Because the first taxable year in which at least one member of the group has QREs and at least one member of the group has gross receipts begins after December 31, 1983, the group is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section. Because the 2004 taxable year is the fifth taxable year beginning after December 31, 1993, for which at least one member of the group had QREs, under section 41(c)(3)(B)(ii)(I), the group’s fixed-base percentage is 3 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, the stand-alone entity

credit for each member of the consolidated group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for each of K (\$25.5x), L (\$2.5x), and M (\$10x) is greater using the method described in section 41(a). Therefore the stand-alone entity credits for each of K, L, and M must be computed using the method described in section 41(a). The sum of the stand-alone entity credits of all the members of the group is \$38x. Because the group credit of \$38x is equal to sum of the stand-alone entity credits of all the members of the group (\$38x), the group credit is allocated among the members of the group based on the ratio that each member’s stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The \$38x group credit is allocated as follows:

	K	L	M	Total
Stand-Alone Entity Credit	\$25.5x	\$2.5x	\$10x	\$38x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	25.5/38	2.5/38	10/38	
Multiplied by: Group Credit	\$38x	\$38x	\$38x	
Equals: Credit Allocated to Member	\$25.5x	\$2.5x	\$10x	\$38x

Example 6. Group alternative incremental research credit—(i) Facts. N, O, and P, all of which are calendar-year taxpayers, are members of a controlled group. The research credit under section 41(a) is not

allowable to the group for the 2004 taxable year because the group’s aggregate QREs for the 2004 taxable year are less than the group’s base amount. The group credit is computed using the AIRC rules of sec-

tion 41(c)(4). For purposes of computing the group credit for the 2004 taxable year (the credit year), N, O, and P had the following:

	N	O	P	Group Aggregate
Credit Year QREs	\$0x	\$20x	\$110x	\$130x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	\$1,200x	\$200x	\$300x	\$1,700x

(ii) *Computation of the group credit.* The research credit allowable to the group is computed as if N, O, and P were one taxpayer. The group credit is equal to the sum of: 2.65 percent of so much of the group’s aggregate QREs for the taxable year as exceeds 1 percent of the group’s aggregate average annual gross receipts for the 4 taxable years preceding the credit year, but does not exceed 1.5 percent of such average; 3.2 percent of so much of the group’s aggregate QREs as exceeds 1.5 percent of such average but does not exceed 2 percent of such average; and 3.75 percent of so much of such QREs as exceeds 2 percent of

such average. The group credit is $[0.0265 \times [(\$1,700x \times 0.015) - (\$1,700x \times 0.01)]] + [0.032 \times [(\$1,700x \times 0.02) - (\$1,700x \times 0.015)]] + [0.0375 \times [\$130x - (\$1,700x \times 0.02)]]$, which equals \$4.10x.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for N is zero under either method. The stand-alone entity credit for each of O (\$0.66x) and P (\$3.99x) is greater using the AIRC

method. Therefore, the stand-alone entity credits for each of O and P must be computed using the AIRC method. The sum of the stand-alone entity credits of the members of the group is \$4.65x. Because the group credit of \$4.10x is less than the sum of the stand-alone entity credits of all the members of the group (\$4.65x), the group credit is allocated among the members of the group based on the ratio that each member’s stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The \$4.10x group credit is allocated as follows:

	N	O	P	Total
Stand-Alone Entity Credit	\$0.00x	\$0.66x	\$3.99x	\$4.65x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	0/4.65	0.66/4.65	3.99/4.65	
Multiplied by: Group Credit	\$4.10x	\$4.10x	\$4.10x	
Equals: Credit Allocated to Member	\$0.00x	\$0.58x	\$3.52x	\$4.10x

(f) *For taxable years beginning before January 1, 1990.* For taxable years beginning before January 1, 1990, see §1.41–6 as contained in 26 CFR part 1, revised April 1, 2005.

(g) *Tax accounting periods used—(1) In general.* The credit allowable to a member of a controlled group is that member's share of the group credit computed as of the end of that member's taxable year. In computing the group credit for a group whose members have different taxable years, a member generally should treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. For example, Q, R, and S are members of a controlled group of corporations. Both Q and R are calendar year taxpayers. S files a return using a fiscal year ending June 30. For purposes of computing the group credit at the end of Q's and R's taxable year on December 31, S's fiscal year ending June 30, which ends within Q's and R's taxable year, is treated as S's credit year.

(2) *Special rule when timing of research is manipulated.* If the timing of research by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return may require each member of the group to calculate the credit in the current taxable year and all future years as if all members of the group had the same taxable year and base period as the computing member.

(h) *Membership during taxable year in more than one group.* A trade or business may be a member of only one group for a taxable year. If, without application of this paragraph, a business would be a member of more than one group at the end of its taxable year, the business shall be treated as a member of the group in which it was

included for its preceding taxable year. If the business was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the business shall designate in its timely filed (including extensions) return the group in which it is being included. If the return for a taxable year is due before July 1, 1983, the business may designate its group membership through an amended return for that year filed on or before June 30, 1983. If the business does not so designate, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return will determine the group in which the business is to be included.

(i) *Intra-group transactions—(1) In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.

(2) *In-house research expenses.* If one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its QREs any in-house research expenses for that work and shall not treat any amount received or accrued as funding the research. Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is qualified research, the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.

(3) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as QREs. However, if the expenses are not paid or incurred in carrying on any trade or business of that mem-

ber, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(i) Reimburses the member paying or incurring the expenses; and

(ii) Carries on a trade or business to which the research relates.

(4) *Lease Payments.* The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 41. Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member; or

(ii) The amount of the lease expenses paid to the person outside the group.

(5) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member; or

(ii) The amount of the other member's basis in the supplies.

(j) *Effective date.* These temporary regulations are applicable for taxable years ending on or after May 24, 2005. Generally, a taxpayer may use any reasonable method of computing and allocating the credit for taxable years ending before May 24, 2005. However, paragraph (b), relating to the computation of the group credit, and paragraph (c), relating to the allocation of the group credit, will apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different tax-

able years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

§1.41–8 [Removed]

Par. 5. Section 1.41–8 is removed.

Par. 6. Section 1.41–8T is added to read as follows:

§1.41–8T Special rules for taxable years ending on or after January 3, 2001 (temporary).

(a) *Alternative incremental credit.* At the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(4).

(b) *Election—(1) In general.* A taxpayer may elect to apply the provisions of the alternative incremental research credit (AIRC) in section 41(c)(4) for any taxable year of the taxpayer beginning after June 30, 1996. If a taxpayer makes an election under section 41(c)(4), the election applies to the taxable year for which made and all subsequent taxable years unless revoked in the manner prescribed in paragraph (b)(3) of this section.

(2) *Time and manner of election.* An election under section 41(c)(4) is made by completing the portion of Form 6765, “Credit for Increasing Research Activities,” relating to the election of the AIRC, and attaching the completed form to the taxpayer’s timely filed (including extensions) original return for the taxable year to which the election applies. An election under section 41(c)(4) may not be made on an amended return.

(3) *Revocation.* An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer is deemed to have requested, and to have been granted, the consent of the Commissioner to revoke an election under section 41(c)(4) if the taxpayer completes the portion of Form 6765 relating to the regular credit and attaches the completed form to the taxpayer’s timely filed (including extensions) original return for the year to which the revocation applies. An election under section 41(c)(4) may not be revoked on an amended return.

(4) *Special rules for controlled groups—(i) In general.* In the case of

a controlled group of corporations, all the members of which are not included on a single consolidated return, the designated member must make (or revoke) an election under section 41(c)(4) on behalf of the members of the group. An election (or revocation) by the designated member under this paragraph (b)(4) of this section shall be binding on all the members of the group for the credit year to which the election (or revocation) relates.

(ii) *Designated member.* For purposes of this paragraph (b)(4) of this section, for any credit year, the term *designated member* means that member of the group that is allocated the greatest amount of the group credit under paragraph (c) of §1.41–6T. If the members of a group compute the group credit using different methods (either the method described in section 41(a) or the AIRC method of section 41(c)(4)) and at least two members of the group qualify as the designated member, then the term *designated member* means that member that computes the group credit using the method that yields the greater group credit. For example, A, B, C, and D are members of a controlled group but are not members of a consolidated group. For the 2005 taxable year, the group credit using the method described in section 41(a) is \$10x. Under this method, A would be allocated \$5x of the group credit, which would be the largest share of the group credit under this method. For the 2005 taxable year, the group credit using the AIRC method is \$15x. Under the AIRC method, C would be allocated \$5x of the group credit, which is the largest share of the group credit computed using the AIRC method. Because the group credit is greater using the AIRC method and C is allocated the greatest amount of credit under that method, C is the designated member. Therefore, C’s section 41(c)(4) election is binding on all the members of the group for the 2005 taxable year.

(5) *Effective date.* These temporary regulations are applicable for taxable years ending on or after May 24, 2005.

Mark E. Matthews,
Deputy Commissioner for
Services and Enforcement.

Approved May 16, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 24, 2005, 70 F.R. 29596)

Section 143.—Mortgage Revenue Bonds: Qualified Mortgage Bond and Qualified Veterans’ Mortgage Bond

26 CFR 1.143(g)–1: Requirements related to arbitrage.

T.D. 9204

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Mortgage Revenue Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the limitation on the effective rate of mortgage interest for purposes of mortgage revenue bonds issued by State and local governments. These regulations provide guidance to State and local governments that issue tax-exempt mortgage revenue bonds.

DATES: *Effective Date:* These regulations are effective May 23, 2005.

Applicability Date: For dates of applicability, see §1.143(g)–1(d) of these regulations.

FOR FURTHER INFORMATION CONTACT: Michael P. Brewer, (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) under section 143(g) of the Internal Revenue Code by providing rules regarding the limitation on the effective rate of mortgage interest

for purposes of mortgage revenue bonds issued by State and local governments. On November 5, 2003, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-146692-03, 2003-2 C.B. 1164 [68 FR 62549]) (the proposed regulations). The proposed regulations would add §1.143(g)-1 to provide rules for calculating the effective rate of mortgage interest. A public hearing on the proposed regulations was scheduled for January 28, 2004. The public hearing was cancelled because no requests to speak were received. Written comments were received regarding the proposed regulations. After consideration of the written comments, the proposed regulations are adopted by this Treasury decision without change (other than certain clarifying changes to the effective date provisions).

A. Mortgage Revenue Bonds

Section 103(a) of the Internal Revenue Code of 1986 (Code) provides that, generally, interest on any State or local bond is not included in gross income. However, this exclusion does not apply to any private activity bond that is not a qualified bond.

Section 141(e)(1) provides that a qualified mortgage bond or a qualified veterans' mortgage bond (together, mortgage revenue bonds) issued under section 143 may be a qualified bond.

Sections 143(a)(2)(A)(ii) and 143(b) provide, in part, that for an issue to be an issue of qualified mortgage bonds or qualified veterans' mortgage bonds, respectively, the issue must satisfy the requirements of section 143(g). Section 143(g)(1) provides that an issue will meet the requirements of section 143(g) if the issue satisfies the requirements of section 143(g)(2) and, in the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, if the issue satisfies the requirements of section 143(g)(3).

Section 143(g)(2)(A) provides that an issue will meet the requirements of section 143(g)(2) only if the excess of (1) the effective interest rate on the mortgages provided under the issue, over (2) the yield on the issue, is not greater than 1.125 percentage points.

Section 143(g)(2)(B)(i) provides that in determining the effective rate of interest on any mortgage for purposes of section

143(g)(2), all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or the bond issue are taken into account as additional interest paid.

Section 143(g)(2)(B)(ii) provides that, for purposes of determining the effective rate of mortgage interest, the following items (among others) shall be treated as borne by the mortgagor: (1) All points or similar charges paid by the seller of the property; and (2) the excess of the amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property when owner-financing is not provided through the use of mortgage revenue bonds.

Section 143(g)(2)(B)(iii) provides that, for purposes of determining the effective rate of mortgage interest, the following items shall not be taken into account: (1) Any expected rebate of arbitrage profits; and (2) any application fee, survey fee, credit report fee, insurance charge, or similar amount to the extent such amount does not exceed amounts charged in such area in cases when owner-financing is not provided through the use of mortgage revenue bonds. The exclusion for application fees, survey fees, credit report fees, insurance charges, or similar amounts does not apply to origination fees, points, or similar amounts.

In the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, section 143(g)(3) provides that certain earnings on nonpurpose investments must either be paid or credited to mortgagors, or paid to the United States, in certain circumstances.

In the Tax Reform Act of 1986, Public Law 99-514 (the 1986 Act), Congress reorganized sections 103 and 103A of the Internal Revenue Code of 1954 (1954 Code) regarding tax-exempt bonds into sections 103 and 141 through 150 of the Code. Congress intended that to the extent not amended by the 1986 Act, all principles of pre-1986 Act law would continue to apply to the reorganized provisions. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686.

Interpreting section 103A(i)(2)(B)(iii) of the 1954 Code, which is substantially

identical to section 143(g)(2)(B)(iii) of the Code, §6a.103A-2(i)(2)(ii)(C) of the Temporary Income Tax Regulations provides the following: "For example, amounts paid for FHA, VA, or similar private mortgage insurance on an individual's mortgage need not be taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not financed with qualified mortgage bonds. Premiums charged for pool mortgage insurance will be considered amounts in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds." Pool mortgage insurance is not defined in the regulations.

B. Qualified Guarantees

Under §1.148-4(f), for purposes of computing yield on an issue, fees paid for a qualified guarantee for the issue are treated as additional interest on the issue. In general, a guarantee is a qualified guarantee if: (1) As of the date the guarantee is obtained, the issuer reasonably expects that the present value of the fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee; (2) the arrangement creates a guarantee in substance; and (3) the fees for the guarantee do not exceed a reasonable, arm's-length charge for the transfer of credit risk. The regulations provide that the guarantee of a loan of proceeds of an issue, as opposed to a guarantee of the issue, may constitute a qualified guarantee, but this rule does not apply to guarantees of mortgages financed with mortgage revenue bonds.

Explanation of Provisions

A. Pool Mortgage Insurance

Prior to the issuance of the proposed regulations, questions arose regarding whether an issuer should be required to treat the portion of the interest payments on a pool of mortgages used to pay fees for a guarantee of a pass-through security backed by the pool of mortgages as an amount borne by the mortgagors that must be taken into account in determining the effective rate of interest on the mortgages for purposes of section 143(g). Taking the guarantee fees into account results in

a higher effective rate of interest on the mortgages than if the fees were not taken into account.

The IRS and Treasury Department have determined that the guarantee fees should not be treated as amounts borne by the mortgagors that must be taken into account in determining the effective rate of interest on the mortgages for purposes of section 143(g). An issuer may achieve substantially the same result as not taking the guarantee fees into account in computing the effective rate of interest on the mortgages by substituting a qualified guarantee on the bonds for the guarantee of the pool of mortgages. If an issuer does not take the mortgage guarantee fees into account in computing the effective rate of interest on the mortgages, the difference between the bond yield and the effective rate on the mortgages is reduced because the effective rate on the mortgages is reduced. A qualified guarantee of the bonds accomplishes the same result by increasing bond yield, rather than reducing the effective rate of interest on the mortgages. Issuers should not be required to change the form of their transactions in these circumstances.

Accordingly, to the extent the amounts charged for a guarantee of a pool of mortgages do not exceed amounts charged in the area in cases when owner-financing is not provided through the use of mortgage revenue bonds, the proposed regulations would provide that such amounts are not treated as borne by the mortgagors and are not taken into account in determining the effective rate of interest on the mortgages for purposes of section 143(g).

B. Proposed Regulations

The proposed regulations propose a new §1.143(g)-1. The proposed regulations provide that an issue satisfies the requirements of section 143(g) only if the issue meets the requirements of §1.143(g)-1(b) and, in the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, the issue also meets the requirements of §1.143(g)-1(c). The requirements of section 143(g) and the proposed regulations are applicable in addition to the requirements of section 148 and §§1.148-0 through 1.148-11.

The proposed regulations provide that an issue shall be treated as meeting the re-

quirements of §1.143(g)-1(b) only if the excess of (1) the effective rate of interest on the mortgages financed by the issue, over (2) the yield on the issue, is not greater over the term of the issue than 1.125 percentage points.

In determining the effective rate of interest on any mortgage, the proposed regulations provide that all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or to the bond issue are taken into account. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

The proposed regulations provide that items that are treated as borne by the mortgagor and are taken into account in calculating the effective rate of interest also include: (1) All points, commitment fees, origination fees, or similar charges borne by the seller of the property; and (2) the excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property where owner-financing is not provided through the use of mortgage revenue bonds.

The proposed regulations further provide that the following items are not treated as borne by the mortgagor and are not taken into account in calculating the effective rate of interest: (1) Any expected rebate of arbitrage profit; and (2) any application fee, survey fee, credit report fee, insurance charge or similar settlement or financing cost to the extent such amount does not exceed amounts charged in the area in cases where owner-financing is not provided through the use of mortgage revenue bonds.

With respect to insurance charges, the proposed regulations provide that amounts paid for Federal Housing Administration, Veterans' Administration, or similar private mortgage insurance on an individual's mortgage, or amounts paid for pool mortgage insurance on a pool of mortgages, are not taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage, or pool of mortgages, that is not financed with mortgage revenue bonds. Moreover, for this purpose, amounts paid for pool mortgage insurance include amounts paid to an entity

(for example, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or other mortgage insurer) to directly guarantee the pool of mortgages financed with the bonds, or to guarantee a pass-through security backed by the pool of mortgages financed with the bonds.

The proposed regulations do not provide guidance regarding all aspects of the application of section 143(g)(2). The proposed regulations provide that to the extent not inconsistent with the 1986 Act or subsequent law, the provisions of §6a.103A-2(i)(2) (other than paragraphs (i)(2)(i) and (i)(2)(ii)(A) through (C)) apply to provide additional rules relating to compliance with the requirement that the effective rate of mortgage interest not exceed the bond yield by more than 1.125 percentage points.

The proposed regulations also do not provide guidance regarding the application of section 143(g)(3). The proposed regulations provide that to the extent not inconsistent with the 1986 Act or subsequent law, the provisions of §6a.103A-2(i)(4) apply to provide guidance regarding the application of section 143(g)(3).

C. Final Regulations

All of the public comments expressed support for the proposed regulations as proposed, and the proposed regulations are adopted by this Treasury decision without change other than certain changes to the effective date provisions to reflect that the regulations are being issued in final form.

Effective Dates

The final regulations apply to bonds sold on or after May 23, 2005, that are subject to section 143. Issuers may apply the final regulations in whole, but not in part, to bonds sold before May 23, 2005, that are subject to section 143. Subject to the applicable effective dates for the corresponding statutory provisions, issuers may apply the final regulations, in whole, but not in part, to bonds that are subject to section 103A(i) of the Internal Revenue Code of 1954. To the extent that an issuer applies the final regulations to bonds that were issued before July 1, 1993, §6a.103A-2(i)(3) also applies.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Timothy L. Jones and Michael P. Brewer, Office of Associate Chief Counsel (Tax-exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.143(g)-1 is added to read as follows:

§1.143(g)-1 Requirements related to arbitrage.

(a) *In general.* Under section 143, for an issue to be an issue of qualified mortgage bonds or qualified veterans' mortgage bonds (together, mortgage revenue bonds), the requirements of section 143(g) must be satisfied. An issue satisfies the requirements of section 143(g) only if such issue meets the requirements of paragraph (b) of this section and, in the case of an

issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, such issue also meets the requirements of paragraph (c) of this section. The requirements of section 143(g) and this section are applicable in addition to the requirements of section 148 and §§1.148-0 through 1.148-11.

(b) *Effective rate of mortgage interest not to exceed bond yield by more than 1.125 percentage points—*(1) *Maximum yield.* An issue shall be treated as meeting the requirements of this paragraph (b) only if the excess of the effective rate of interest on the mortgages financed by the issue, over the yield on the issue, is not greater over the term of the issue than 1.125 percentage points.

(2) *Effective rate of interest.* (i) In determining the effective rate of interest on any mortgage for purposes of this paragraph (b), there shall be taken into account all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or to the bond issue. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

(ii) Items that shall be treated as borne by the mortgagor and shall be taken into account in calculating the effective rate of interest also include—

(A) All points, commitment fees, origination fees, or similar charges borne by the seller of the property; and

(B) The excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property when owner-financing is not provided through the use of mortgage revenue bonds.

(iii) The following items shall not be treated as borne by the mortgagor and shall not be taken into account in calculating the effective rate of interest—

(A) Any expected rebate of arbitrage profit under paragraph (c) of this section; and

(B) Any application fee, survey fee, credit report fee, insurance charge or similar settlement or financing cost to the extent such amount does not exceed amounts charged in the area in cases when owner-financing is not provided through the use of mortgage revenue bonds. For

example, amounts paid for Federal Housing Administration, Veterans' Administration, or similar private mortgage insurance on an individual's mortgage, or amounts paid for pool mortgage insurance on a pool of mortgages, are not taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage, or pool of mortgages, that is not financed with mortgage revenue bonds. For this purpose, amounts paid for pool mortgage insurance include amounts paid to an entity (for example, the Government National Mortgage Association, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation, or other mortgage insurer) to directly guarantee the pool of mortgages financed with the bonds, or to guarantee a pass-through security backed by the pool of mortgages financed with the bonds.

(C) The following example illustrates the provisions of this paragraph (b)(2)(iii):

Example. Housing Authority X issues bonds intended to be qualified mortgage bonds under section 143(a). At the time the bonds are issued, X enters into an agreement with a group of mortgage lending institutions (lenders) under which the lenders agree to originate and service mortgages that meet certain specified requirements. After originating a specified amount of mortgages, each lender issues a "pass-through security" (each, a PTS) backed by the mortgages and sells the PTS to X. Under the terms of the PTS, the lender pays X an amount equal to the regular monthly payments on the mortgages (less certain fees), whether or not received by the lender (plus any prepayments and liquidation proceeds in the event of a foreclosure or other disposition of any mortgages). FNMA guarantees the timely payment of principal and interest on each PTS. From the payments received from each mortgagor, the lender pays a fee to FNMA for its guarantee of the PTS. The amounts paid to FNMA do not exceed the amounts charged in the area with respect to a similar pool of mortgages that is not financed with mortgage revenue bonds. Under this paragraph (b)(2)(iii), the fees for the guarantee provided by FNMA are an insurance charge because the guarantee is pool mortgage insurance. Because the amounts charged for the guarantee do not exceed the amounts charged in the area with respect to a similar pool of mortgages that is not financed with mortgage revenue bonds, the amounts charged for the guarantee are not taken into account in computing the effective rate of interest on the mortgages financed with X's bonds.

(3) *Additional rules.* To the extent not inconsistent with the Tax Reform Act of 1986, Public Law 99-514 (the 1986 Act), or subsequent law, §6a.103A-2(i)(2) (other than paragraphs (i)(2)(i) and (i)(2)(ii)(A) through (C)) of this chapter applies to provide additional rules relating

to compliance with the requirement that the effective rate of mortgage interest not exceed the bond yield by more than 1.125 percentage points.

(c) *Arbitrage and investment gains to be used to reduce costs of owner-financing.* As provided in section 143(g)(3), certain earnings on nonpurpose investments must either be paid or credited to mortgagors, or paid to the United States, in certain circumstances. To the extent not inconsistent with the 1986 Act or subsequent law, §6a.103A-2(i)(4) of this chapter applies to provide guidance relating to compliance with this requirement.

(d) *Effective dates—(1) In general.* Except as otherwise provided in this section, §1.143(g)-1 applies to bonds sold on or after May 23, 2005, that are subject to section 143.

(2) *Permissive retroactive application in whole.* Except as provided in paragraph (d)(4) of this section, issuers may apply §1.143(g)-1, in whole, but not in part, to bonds sold before May 23, 2005, that are subject to section 143.

(3) *Bonds subject to the Internal Revenue Code of 1954.* Except as provided in paragraph (d)(4) of this section and subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply §1.143(g)-1, in whole, but not in part, to bonds that are subject to section 103A(i) of the Internal Revenue Code of 1954.

(4) *Special rule for pre-July 1, 1993 bonds.* To the extent that an issuer applies this section to bonds issued before July 1, 1993, §6a.103A-2(i)(3) of this chapter also applies to the bonds.

Mark E. Matthews,
Deputy Commissioner for
Services and Enforcement.

Approved May 12, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary
of the Treasury.

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 23, 2005, 70 F.R. 29447)

Section 6050L.—Returns Relating to Certain Donated Property

26 CFR 1.6050L-2T: Information returns by donees relating to qualified intellectual property contributions (temporary).

T.D. 9206

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Information Returns by Donees Relating to Qualified Intellectual Property Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance for the filing of information returns by donees relating to qualified intellectual property contributions. These temporary regulations affect donees receiving net income from qualified intellectual property contributions made after June 3, 2004. The text of these temporary regulations also serves as the text of the proposed regulations (REG-158138-04) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective May 23, 2005.

FOR FURTHER INFORMATION CONTACT: Donnell M. Rini-Swyers, (202) 622-4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number

1545-1932. Responses to this collection of information are required to obtain a tax benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Explanation of Provisions

This document contains temporary Income Tax Regulations under the American Jobs Creation Act of 2004 (Public Law 108-357, 118 Stat. 1418) (the Act). They are necessary to implement section 882 of the Act, which directs that regulations be issued regarding information returns by donees relating to qualified intellectual property contributions made after June 3, 2004.

The Act provides rules that under specified conditions enable taxpayers who donate qualified intellectual property to receive additional charitable contribution deductions if and when their donated property produces net income for the donee (qualified donee income). Section 170(m)(2), (8), (9). Under the Act, a taxpayer who contributes a “patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property,” to a donee described in section 170(c) (other than to a private foundation referred to in section 170(e)(1)(B)(ii)) may be allowed an initial charitable contribution deduction limited to the lesser of the taxpayer’s basis or the fair market value of the qualified intellectual property. In

addition, the taxpayer may be permitted to deduct certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received by the donee with respect to the qualified intellectual property.

Section 882(c)(1) of the Act amended section 6050L to require donees to make an annual information return that reports the qualified donee income for the taxable year and other specified information relating to qualified intellectual property contributions. The Service expects to issue a new Form 8899 on which donees will report qualified donee income.

Under section 170(m)(8)(B), a donor must notify the donee of the donor's intent to treat a charitable contribution as a qualified intellectual property contribution under sections 170(m) and 6050L. For rules relating to donor notification, see section 170(m)(8)(B) and Notice 2005-41, 2005-23 I.R.B. 1203, issued thereunder. Unless timely notice is provided, the donor has not made a qualified intellectual property contribution, and the donee has no reporting obligation under section 6050L or these regulations.

The donee is not required to make an information return if the qualified intellectual property produced no net income for the donee's taxable year. Under section 170(m)(5) and (m)(6), income received or accrued during the donee's taxable year is not treated as allocated to qualified intellectual property if such income is received or accrued after the 10-year period beginning on the date of the contribution or after the expiration of the legal life of the qualified intellectual property. Thus, the donee is not required to make a return with regard to a qualified intellectual property contribution for taxable years beginning after the expiration of the legal life of such qualified intellectual property. Additionally, section 6050L(b) requires a return only for specified taxable years of the donee, which years are defined in section 6050L(b)(2)(B) as any taxable year any portion of which is part of the 10-year period beginning on the date of contribution of the qualified intellectual property. Therefore, the donee is not required to make a return for taxable years beginning more than 10 years after the date of the qualified intellectual property contribution.

Under these regulations, the donee generally is required to file an information return (with a copy of such return to the donor) on or before the last day of the first full month following the close of the donee's taxable year. See section 7701(a)(23) for the definition of taxable year. Transition rules are provided to take into account these filing requirements before a form is prescribed by the Internal Revenue Service and for donees' taxable years ending prior to or on the date of issuance of these regulations.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble of the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Donnell M. Rini-Swyers, Office of Associate Chief Counsel (Procedure and Administration).

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6050L-2T is added to read as follows:

§1.6050L-2T Information returns by donees relating to qualified intellectual property contributions (temporary).

(a) *In general.* Each donee organization described in section 170(c), except a

private foundation (as defined in section 509(a)), other than a private foundation described in section 170(b)(1)(E), that receives or accrues net income during a taxable year from any qualified intellectual property contribution (as defined in section 170(m)(8)) must make an annual information return on the form prescribed by the Internal Revenue Service. The information return is required for any taxable year of the donee that includes any portion of the 10-year period beginning on the date of the contribution, but not for taxable years beginning after the expiration of the legal life of the qualified intellectual property.

(b) *Information required to be provided on return.* The information return required by section 6050L and paragraph (a) of this section shall include the following—

(1) The name, address, taxable year, and employer identification number of the donee making the information return;

(2) The name, address, and taxpayer identification number of the donor;

(3) A description of the qualified intellectual property in sufficient detail to identify the qualified intellectual property received by such donee;

(4) The date of the contribution to the donee;

(5) The amount of net income of the donee for the taxable year that is properly allocable to the qualified intellectual property (determined without regard to paragraph (10)(B) of section 170(m) and with the modifications described in paragraphs (5) and (6) of such section); and

(6) Such other information as may be specified by the form or its instructions.

(c) *Special rule—statement to be furnished to donors—(1) In general.* Every donee making an information return under section 6050L and this section with respect to a qualified intellectual property contribution shall furnish a copy of the information return to the donor of the property. The information return required by section 6050L and this section shall be furnished to the donor on or before the date the donee is required to file the return with the Internal Revenue Service.

(2) *Before a form is prescribed by the Internal Revenue Service.* Before a form is prescribed by the Internal Revenue Service, every donee required to make an information return under section 6050L and this section with respect to qualified in-

tellectual property contributions shall furnish, in lieu of the prescribed form, a statement to the donor that includes all information required by paragraphs (b)(1) through (b)(5) of this section. This statement shall be furnished to the donor on or before the date the donee would have been required to file the return with the Internal Revenue Service under paragraph (d)(2)(i) of this section had a form been prescribed.

(3) *Donee taxable years ending prior to or on the date of issuance of regulations.* If the donee's taxable year to which net income from the qualified intellectual property is properly allocable ends prior to or on May 23, 2005, the donee shall furnish the information required under section 6050L and this section to the donor on or before August 22, 2005.

(d) *Place and time for filing information return—(1) Place for filing.* The information return required by section 6050L and

this section shall be filed with the Internal Revenue Service location listed on the prescribed form or in its instructions.

(2) *Time for filing—(i) In general.* A donee is required to file the return required by section 6050L and this section on or before the last day of the first full month following the close of the donee's taxable year to which net income from the qualified intellectual property is properly allocable.

(ii) *Before a form is prescribed by the Internal Revenue Service.* If the information return required by section 6050L and this section is required to be filed before a form is prescribed by the Internal Revenue Service, then an information return for such taxable year shall be filed on or before the last day of the second full month following the release of such prescribed form by the Internal Revenue Service.

(e) *Penalties.* For penalties for failure to comply with the requirements of this section, see sections 6721 through 6724.

(f) *Effective date.* The rules of this section apply to qualified intellectual property contributions made after June 3, 2004.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 9. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

§602.101 *OMB Control numbers.*

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.6050L-2T	1545-1932
* * * * *	

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved May 16, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 23, 2005, 70 FR. 29450)

Section 7701.—Definitions

26 CFR 301.7701-3: *Classification of certain business entities.*

T.D. 9203

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301**

Deemed Election To Be an Association Taxable as a Corporation for a Qualified Electing S Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that deem certain eligible entities that file timely S corporation elections

to have elected to be classified as associations taxable as corporations. These regulations affect certain eligible entities filing timely elections to be S corporations on or after July 20, 2004.

DATES: *Effective Date:* These regulations are effective July 20, 2004.

FOR FURTHER INFORMATION CONTACT: Rebekah A. Myers, (202) 622-3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 301. On July 20, 2004, temporary regulations (T.D. 9139, 2004-38 I.R.B. 495), relating to entity classification elections for entities that elect to be S corporations under section 1362(a) were published in the **Federal Register** (69 FR 43317). A notice of proposed rulemaking (REG-131786-03, 2004-38 I.R.B. 500) cross-referencing the temporary regulations also was published in the **Federal**

Register on July 20, 2004. No public hearing was requested or held. No written or electronic comments responding to the notice of proposed rulemaking were received. The proposed regulations are adopted by this Treasury decision, and the corresponding temporary regulations are removed.

Section 301.7701-3(a) provides that an eligible entity with two or more owners may elect to be classified as an association (and thus a corporation under §301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner may elect to be classified as an association or to be disregarded as an entity separate from its owner. Section 301.7701-3(b) provides that, unless the entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is disregarded as an entity separate from its owner if it has a single owner. Section 301.7701-3(c) describes the time and place for filing an entity classification election. Section 301.7701-3(c)(1)(i) provides that an eligible entity may elect to be classified as other than its default classification or to change its classification by filing Form 8832, "Entity Classification Election", with the service center designated on the form.

A taxpayer whose default classification is a partnership or a disregarded entity may seek to be classified as an S corporation. For S elections that were filed prior to the effective date of these regulations, the taxpayer was required to elect to be classified as an association under §301.7701-3(c)(1)(i) by filing Form 8832 and to elect to be an S corporation under section 1362(a) by filing Form 2553, "Election by a Small Business Corporation." These regulations simplify these paperwork requirements by eliminating, in certain cases, the requirement that the entity elect to be classified as an association. Instead, an eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation.

If the S election and the entity classification election are filed late, the entity may need to submit a ruling request under §301.9100-3 to file a late entity classification election and under section 1362(b)(5)

to file a late S corporation election. However, Rev. Proc. 2004-48, 2004-32 I.R.B. 172, provides relief for these entities in some cases.

Effective Dates

These final regulations apply to elections to be an S corporation filed on or after July 20, 2004. However, eligible entities that timely filed S elections before July 20, 2004, may also rely on the provisions of the regulation.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that preceded these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this regulation is Rebekah A. Myers, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 ***

Par. 2. Section 301.7701-3 is amended by revising paragraphs (c)(1)(v)(C) and (h)(3) to read as follows:

§301.7701-3 Classification of certain business entities.

- (c) ***
- (1) ***
- (v) ***

(C) *S corporations.* An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to §301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under §301.7701-3(c)(1)(i), to be classified as other than an association.

- (h)***

(3) *Deemed elections for S corporations.* Paragraph (c)(1)(v)(C) of this section applies to timely S corporation elections under section 1362(a) filed on or after July 20, 2004. Eligible entities that filed timely S elections before July 20, 2004, may also rely on the provisions of the regulation.

§301.7701-3T [Removed].

Par. 3. Section 301.7701-3T is removed.

Mark E. Matthews,
Deputy Commissioner for
Services and Enforcement.

Approved May 12, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary
for Tax Policy.

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 23, 2005, 70 F.R. 29452)

Part III. Administrative, Procedural, and Miscellaneous

Charitable Contributions of Certain Motor Vehicles, Boats, and Airplanes

Notice 2005-44

SECTION 1. PURPOSE

This notice provides interim guidance regarding section 884 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004), which adds §§ 170(f)(12) and 6720 to the Internal Revenue Code. Section 170(f)(12) contains rules for determining the amount that a donor may deduct for a charitable contribution of a qualified vehicle the claimed value of which is more than \$500, and related substantiation and information reporting requirements. Section 6720 imposes penalties on a donee organization that receives a contribution of a qualified vehicle subject to § 170(f)(12) and knowingly furnishes a false or fraudulent acknowledgment of the contribution to the donor, or knowingly fails to furnish the acknowledgment. Sections 170(f)(12) and 6720 apply to contributions made after December 31, 2004. This notice also invites comments from the public regarding this notice and suggestions for future guidance under §§ 170(f)(12) and 6720. The rules provided in this notice apply until regulations are effective.

SECTION 2. BACKGROUND

Section 170(a) allows as a deduction, subject to certain limitations, any charitable contribution (as defined in § 170(c)), payment of which is made within the taxable year. Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution, reduced as provided in § 170(e) and §§ 1.170A-4 and 1.170A-4A.

In general, § 1.170A-1(h) provides that if a taxpayer transfers to a charitable organization cash or property that is partly a charitable contribution and partly in consideration for goods or services, the taxpayer is allowed a charitable contribution deduction for the excess, if any, of the

cash or fair market value of the property transferred over the fair market value of the goods or services the organization provides in return. See also *United States v. American Bar Endowment*, 477 U.S. 105, 117-118 (1986); Rev. Rul. 67-246, 1967-2 C.B. 104.

Section 170(f)(12)(A)(i) provides that no deduction is allowed under § 170(a) for a contribution of a qualified vehicle the claimed value of which is more than \$500 unless the donor substantiates the contribution by a contemporaneous written acknowledgment that meets the requirements of § 170(f)(12)(B). Section 170(f)(12)(A)(i) also provides that the substantiation rules of § 170(f)(8) do not apply to a contribution of a qualified vehicle the claimed value of which is more than \$500.

In general, to meet the requirements of § 170(f)(12)(B), the acknowledgment must include: the name and taxpayer identification number of the donor; the vehicle identification number; and certain certifications, depending on the use or disposition of the vehicle by the donee organization. See section 3.03 of this notice for all of the requirements applicable to acknowledgments. To be considered contemporaneous, the acknowledgment must be obtained within 30 days of the contribution or the disposition of the vehicle by the donee organization, as applicable. See § 170(f)(12)(C) and section 3.03 of this notice. A copy of the acknowledgment must be included with the donor's tax return on which the deduction is claimed. Section 170(f)(12)(E) defines a qualified vehicle as any (i) motor vehicle manufactured primarily for use on public streets, roads, and highways, (ii) boat, or (iii) airplane, but the term does not include any property described in § 1221(a)(1) (e.g., property held primarily for sale to customers).

If a donee organization sells a qualified vehicle without any significant intervening use or material improvement by the donee organization, the deduction allowed under § 170(a) may not exceed the gross proceeds received from the sale, which must be reported on the acknowledgment. See § 170(f)(12)(A)(ii). Section 170(f)(12)(F) provides that the Secretary may prescribe regulations or other guidance that exempts

from the gross proceeds limitation and certain certification requirements sales by the donee organization that are in direct furtherance of the organization's charitable purpose. Section 170(f)(12)(F) also provides that the Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of § 170(f)(12).

SECTION 3. DEDUCTIONS IN EXCESS OF \$500

3.01 *General rule*

If the claimed value of a donated qualified vehicle exceeds \$500, the amount of the deduction may be limited under § 170(f)(12), depending on the use of the qualified vehicle by the donee organization (as described in section 3.02 of this notice). In addition, under § 170(f)(12) the donor must obtain from the donee organization an acknowledgment that meets the requirements of section 3.03 of this notice, and include the acknowledgment with the tax return on which the deduction is claimed.

3.02 *Disposition or use by donee organization*

(1) *Qualified vehicle sold by donee organization*

If the qualified vehicle is sold by the donee organization without a significant intervening use or material improvement by the donee organization, then (except as provided in section 3.02(3) of this notice) the deduction claimed by the donor may not exceed the gross proceeds received from the sale of the qualified vehicle. In no event may the deduction for a donated vehicle exceed the amount that is otherwise allowable under § 170(a) (fair market value). The donor must obtain from the donee organization an acknowledgment that meets the requirements of section 3.03 of this notice.

(2) *Significant intervening use of or material improvement to a qualified vehicle*

If the donee organization makes a significant intervening use of (within the

meaning of section 7.01(1) of this notice) or material improvement to (within the meaning of section 7.01(2) of this notice) a qualified vehicle, the donor is not subject to the gross proceeds limitation in section 3.02(1) of this notice. However, the deduction claimed by the donor may not exceed the fair market value of the qualified vehicle. The donor must obtain from the donee organization an acknowledgment that meets the requirements of section 3.03 of this notice. In addition, the donor must substantiate the fair market value as described in section 5 of this notice.

(3) Qualified vehicle sold at a price significantly below fair market value (or gratuitously transferred) to needy individual in direct furtherance of donee organization's charitable purpose

Pursuant to § 170(f)(12)(F), the Internal Revenue Service and the Treasury Department hereby provide that the gross proceeds limitation in section 3.02(1) does not apply to a sale on or after January 1, 2005, of a qualified vehicle to a needy individual at a price significantly below fair market value, or a gratuitous transfer to a needy individual, in direct furtherance of a charitable purpose of the donee organization of relieving the poor and distressed or the underprivileged who are in need of a means of transportation. See H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 750 (2004). Mere application of the proceeds from the sale of a qualified vehicle to a needy individual to any charitable purpose does not directly further a donee organization's charitable purpose within the meaning of this section. The donor must obtain from the donee organization an acknowledgment that meets the requirements of section 3.03 of this notice. In addition, the donor must substantiate the fair market value as described in section 5 of this notice.

3.03 Contemporaneous written acknowledgment under § 170(f)(12)

(1) General rule

Under § 170(f)(12), a donor must obtain a contemporaneous written acknowledgment from the donee organization, and include the acknowledgment with the tax return on which the deduction is claimed.

All acknowledgments under § 170(f)(12) must include the name and taxpayer identification number of the donor, the vehicle identification number, and the date of the contribution. Additional information is required depending on the use of the qualified vehicle by the donee organization, as described in sections 3.03(2) through 3.03(4) of this notice.

(2) Qualified vehicle sold by donee organization

For a contribution of a qualified vehicle that is sold by the donee organization without any significant intervening use or material improvement by the donee organization in a sale that is not described in section 3.02(3) of this notice, the acknowledgment also must contain the date the qualified vehicle was sold, a certification that the qualified vehicle was sold in an arm's length transaction between unrelated parties, a statement of the gross proceeds from the sale, and a statement that the deductible amount may not exceed the amount of the gross proceeds. The acknowledgment is considered contemporaneous if the donee organization furnishes the acknowledgment to the donor no later than 30 days after the date of the sale.

Example 1. On October 1, 2005, A contributes a qualified vehicle with a fair market value of \$1,300 to O, an organization that is described in § 170(c). On December 1, 2005, the qualified vehicle is sold without any significant intervening use or material improvement in a sale not described in section 3.02(3) of this notice. Gross proceeds from the sale are \$1,000. On or before December 31, 2005, O provides an acknowledgment to A containing A's name and taxpayer identification number, the vehicle identification number, a statement that the date of the contribution was October 1, 2005, a statement that the date of the sale was December 1, 2005, a certification that the qualified vehicle was sold in an arm's length transaction between unrelated parties, a statement that the gross proceeds of the sale are \$1,000, and a statement that the amount of A's deduction may not exceed the amount of the gross proceeds. The acknowledgment meets the requirements of § 170(f)(12).

(3) Significant intervening use of or material improvement to a qualified vehicle

For a contribution of a qualified vehicle for which the donee organization intends a significant intervening use or material improvement within the meaning of section 7.01 of this notice, the acknowledgment also must contain: 1) a certification and detailed description of a) the in-

tended significant intervening use by the donee organization and the intended duration of the use, or b) the intended material improvement by the donee organization; and 2) a certification that the qualified vehicle will not be sold before completion of the use or improvement. The acknowledgment is considered contemporaneous if the donee organization furnishes the acknowledgment to the donor within 30 days of the date of the contribution.

Example 2. On October 1, 2005, B contributes a qualified vehicle to O, an organization that is described in § 170(c). O intends to use the vehicle in its charitable activities, and the intended use is a significant intervening use within the meaning of section 7.01(1) of this notice. On or before October 31, 2005, O provides an acknowledgment to B containing B's name and taxpayer identification number, the vehicle identification number, a statement that the date of the contribution was October 1, 2005, a certification stating that O intends to make a significant intervening use of the qualified vehicle and stating the duration of this use, a detailed description of the significant intervening use, and a certification that the qualified vehicle will not be transferred in exchange for money, other property, or services before completion of the use by O. The acknowledgment meets the requirements of § 170(f)(12).

(4) Qualified vehicle sold at a price significantly below fair market value (or gratuitously transferred) to needy individual in direct furtherance of donee organization's charitable purpose

For a contribution of a qualified vehicle that meets the requirements of section 3.02(3) of this notice, the acknowledgment also must contain a certification that the donee organization will sell the qualified vehicle to a needy individual at a price significantly below fair market value (or, if applicable, that the donee organization gratuitously will transfer the qualified vehicle to a needy individual) and that the sale (or transfer) will be in direct furtherance of the donee organization's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation. The acknowledgment is considered contemporaneous if the donee organization furnishes the acknowledgment to the donor no later than 30 days after the date of the contribution.

Example 3. On October 1, 2005, C contributes a qualified vehicle to O, an organization that is described in § 170(c). O's charitable purposes include helping needy individuals who are unemployed develop new job skills, finding job placements for these individuals, and providing transportation for these in-

dividuals who need a means of transportation to jobs in areas not served by public transportation. *O* determines that, in direct furtherance of its charitable purpose, *O* will sell the qualified vehicle at a price significantly below fair market value to a trainee who needs a means of transportation to a new workplace. On or before October 31, 2005, *O* provides an acknowledgment to *C* containing *C*'s name and taxpayer identification number, the vehicle identification number, a statement that the date of the contribution was October 1, 2005, a certification that *O* will sell the qualified vehicle to a needy individual at a price significantly below fair market value, and a certification that the sale is in direct furtherance of *O*'s charitable purpose as described above. The acknowledgment meets the requirements of § 170(f)(12).

SECTION 4. DEDUCTIONS OF \$500 OR LESS

4.01 *Contemporaneous written acknowledgment required to substantiate a qualified vehicle contribution of \$250 but not more than \$500*

A contribution of a qualified vehicle with a claimed value of at least \$250 (as determined in accordance with section 5 of this notice) must be substantiated by a contemporaneous written acknowledgment of the contribution by the donee organization. For a qualified vehicle with a claimed value of at least \$250 but not more than \$500, the acknowledgment must contain the following information as required by § 170(f)(8): the amount of cash and a description (but not value) of any property other than cash contributed; whether the donee organization provided any goods or services in consideration, in whole or in part, for the cash or property contributed; and a description and good faith estimate of the value of any goods or services provided by the donee organization in consideration for the contribution, or, if such goods or services consist solely of intangible religious benefits, a statement to that effect. To meet the contemporaneous requirement of § 170(f)(8)(C), the acknowledgment must be obtained by the donor on or before the earlier of the date on which the donor files a return for the taxable year in which the contribution was made, or the due date (including extensions) of that return.

4.02 *Sale of qualified vehicle yields gross proceeds of \$500 or less*

If a donor contributes a qualified vehicle that is subsequently sold, in a sale not

described in section 3.02(3) of this notice, without any significant intervening use or material improvement by the donee organization, and the sale yields gross proceeds of \$500 or less, the donor may be allowed a deduction equal to the lesser of the fair market value of the qualified vehicle on the date of the contribution or \$500, subject to the terms and limitations of § 170. Under these circumstances, the donor must substantiate the fair market value (see section 5 of this notice), and, if the fair market value is \$250 or more, must substantiate the contribution with an acknowledgment that meets the requirements of § 170(f)(8).

Example 4. *D*, an individual who itemizes tax deductions, contributes a qualified vehicle to *O*, an organization that is described in § 170(c). The qualified vehicle is sold without any significant intervening use or material improvement by *O*, and gross proceeds of \$400 are received. In accordance with section 5 of this notice, *D* determined that the fair market value of the qualified vehicle at the time of the contribution was \$800. Provided that *D* timely obtains a written acknowledgment that meets the requirements of § 170(f)(8) (see section 4.01 of this notice), and subject to the terms and limitations of § 170, *D* may be allowed a deduction not to exceed \$500.

Example 5. The facts are the same as in *Example 4*, except that in accordance with section 5 of this notice *D* determined that the fair market value of the qualified vehicle at the time of the contribution was \$450. Provided that *D* timely obtains a written acknowledgment that meets the requirements of § 170(f)(8) (see section 4.01 of this notice), and subject to the terms and limitations of § 170, *D* may be allowed a deduction not to exceed \$450.

SECTION 5. FAIR MARKET VALUE

A donor claiming a deduction for the fair market value of a qualified vehicle must be able to substantiate the fair market value. Section 1.170A-1(c)(2) provides that fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and each having reasonable knowledge of relevant facts.

A reasonable method of determining the fair market value of a qualified vehicle is by reference to an established used vehicle pricing guide. Many factors must be taken into account when using a used vehicle pricing guide to determine fair market value. A used vehicle pricing guide establishes the fair market value of a particular vehicle only if the guide lists a sales price for a vehicle that is the same make, model, and year, sold in the same area, in the same condition, with the same or substantially

similar options or accessories, and with the same or substantially similar warranties or guarantees, as the vehicle in question. *See, e.g.*, Rev. Rul. 2002-67, 2002-2 C.B. 873.

The Service and the Treasury Department intend to issue regulations under § 170 clarifying that for purposes of § 170, the dealer retail value listed in a used vehicle pricing guide for a particular vehicle is not an acceptable measure of fair market value of a similar vehicle. The regulations will clarify that, for purposes of § 170, an acceptable measure of the fair market value of a vehicle, for contributions made after June 3, 2005, and before the date regulations become effective, is an amount not in excess of the price listed in a used vehicle pricing guide for a private party sale of a similar vehicle. The regulations limiting the fair market value of a vehicle to an amount not in excess of the private party sale price will apply to contributions of vehicles made after June 3, 2005. In addition, the Service and the Treasury Department will consider whether other values, such as the dealer trade-in value, are appropriate measures of the fair market value of a vehicle for purposes of § 170. Any regulations limiting the fair market value of a vehicle to an amount less than the private party sale value will not apply to contributions made prior to the date that regulations to that effect become effective.

SECTION 6. QUALIFIED APPRAISAL

A qualified appraisal is required for a deduction in excess of \$5,000 for a qualified vehicle if the deduction is not limited to gross proceeds from the sale of the vehicle. See § 170(f)(11)(A)(ii)(I). For the definition of qualified appraisal, see § 1.170A-13.

SECTION 7. ACKNOWLEDGMENTS BY DONEE ORGANIZATIONS

7.01 *Requirements of significant intervening use; material improvement; sale or gratuitous transfer to needy individual in direct furtherance of donee organization's charitable purpose*

As described in section 3.03 of this notice, the contents of the acknowledgment required under § 170(f)(12) depend upon whether the donee organization sells a qualified vehicle without any significant intervening use or material improvement,

intends to make a significant intervening use of or material improvement to a qualified vehicle prior to sale, or, in direct furtherance of a charitable purpose of the organization of relieving the poor and distressed or the underprivileged who are in need of a means of transportation, intends to sell a qualified vehicle to a needy individual at a price significantly below fair market value, or gratuitously transfer a qualified vehicle to a needy individual. This section provides rules for donee organizations to use in determining the contents of the acknowledgments required under § 170(f)(12).

(1) Significant intervening use

To constitute a significant intervening use, a donee organization must actually use the qualified vehicle to substantially further the organization's regularly conducted activities, and the use must be significant. Incidental use by an organization is not a significant intervening use. Whether a use is a significant intervening use depends on its nature, extent, frequency, and duration. See H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 750–751 (2004). For this purpose, use by the donee organization includes use of the qualified vehicle to provide transportation on a regular basis for a significant period of time or significant use directly related to instruction in vehicle repair. However, use by the donee organization does not include use of the qualified vehicle to provide training in general business skills, such as marketing and sales.

Example 6. E contributes a qualified vehicle to O, an organization that is described in § 170(c). As part of its regularly conducted activities, O delivers meals to needy individuals. O uses the qualified vehicle only a few times to deliver meals and then sells the qualified vehicle. Because O's use is infrequent and incidental, there is no significant intervening use.

Example 7. The facts are the same as in *Example 6*, except that O uses the qualified vehicle to deliver meals every day for one year. Because O's use is significant and substantially furthers a regularly conducted activity of O, there is a significant intervening use.

Example 8. The facts are the same as in *Example 6*, except that O does not use the qualified vehicle to deliver meals every day. However, O drives the qualified vehicle a total of 10,000 miles over a 1-year period while delivering meals. Because O's use is significant and substantially furthers a regularly conducted activity of O, there is a significant intervening use.

(2) Material improvement

Material improvement includes a major repair or improvement that improves the condition of the qualified vehicle in a manner that significantly increases the value. Cleaning, minor repairs, and routine maintenance are not considered material improvements. See H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 751 (2004). To be a material improvement of a qualified vehicle, the improvement may not be funded by an additional payment to the donee organization from the donor of the qualified vehicle.

For purposes of § 170(f)(12), services that are not considered material improvements include: 1) application of paint or other types of finishes (such as rust-proofing or wax); 2) removal of dents and scratches; 3) cleaning or repair of upholstery; and 4) installation of theft deterrent devices.

(3) Sale or gratuitous transfer to needy individual in direct furtherance of donee organization's charitable purpose

As provided in section 3.02(3) of this notice, the gross proceeds limitation does not apply to a sale of a qualified vehicle at a price significantly below fair market value (as described in section 5 of this notice), or a gratuitous transfer of a qualified vehicle, to a needy individual if supplying a vehicle to a needy individual is in direct furtherance of a charitable purpose of the donee organization of relieving the poor and distressed or the underprivileged who are in need of a means of transportation.

7.02 Information reporting by donee organizations

Section 170(f)(12)(D) requires a donee organization to provide to the Secretary the information given to the donor in the acknowledgment required under § 170(f)(12). The time and manner rules for information reporting required under § 170(f)(12)(D) will be addressed in separate guidance. See section 3.03 of this notice for guidance on the content of the acknowledgment.

7.03 Penalties for false or fraudulent acknowledgments and for knowing failure to furnish proper acknowledgment

Section 6720 imposes penalties on any donee organization required under § 170(f)(12)(A) to furnish an acknowledgment to a donor that knowingly furnishes a false or fraudulent acknowledgment, or knowingly fails to furnish an acknowledgment in the manner, at the time, and showing the information required under § 170(f)(12) or regulations thereunder. An acknowledgment containing a certification described in section 3.03(3) or (4) of this notice shall be presumed to be false or fraudulent, and therefore subject to a penalty under § 6720, if the qualified vehicle is sold to a buyer, other than a needy individual as described in section 7.01(3) of this notice, without a significant intervening use or material improvement within six months of the date of the contribution. The penalty applicable to an acknowledgment relating to a qualified vehicle described in section 3.02(1) of this notice is the greater of (1) the product of the highest rate of tax specified in § 1 (currently 35%) and the sales price stated on the acknowledgment, or (2) the gross proceeds from the sale of the qualified vehicle. The penalty applicable to an acknowledgment relating to any other qualified vehicle the claimed value of which is more than \$500 is the greater of (1) the product of the highest rate of tax specified in § 1 and the claimed value of the qualified vehicle, or (2) \$5,000.

Example 9. O, an organization that is described in § 170(c), receives a contribution of a qualified vehicle that is a subcompact car that has been driven more than 100,000 miles. The substance of O's charitable activities involves regularly delivering food and other needed goods to the rural poor at remote locations. For this purpose, O needs three large vehicles suitable for delivering heavy loads across rugged terrain. Among many contributed qualified vehicles, O has identified three suitable vehicles that O intends to use for this purpose. The subcompact car is not suitable for O's use. O provides an acknowledgment to the donor of the subcompact car in which O knowingly makes a false certification of the intended use of the qualified vehicle and the duration of such intended use. The donor of the qualified vehicle claims a deduction of \$2,300. O is subject to a penalty under § 6720 for knowingly furnishing a false or fraudulent acknowledgment to the donor. The amount of the penalty is \$5,000, because that amount is greater than \$805, the product of the claimed value (\$2,300) and 35%.

Example 10. O, an organization that is described in § 170(c), receives a contribution of a qualified ve-

hicle. The qualified vehicle is sold without any significant intervening use or material improvement by *O*. Gross proceeds from the sale are \$300. *O* provides an acknowledgment to the donor in which *O* knowingly includes a false or fraudulent statement that the gross proceeds from the sale of the vehicle were \$1,000. *O* is subject to a penalty under § 6720 for knowingly furnishing a false or fraudulent acknowledgment to the donor. The amount of the penalty is \$350, the product of the sales price stated in the acknowledgment (\$1,000) and 35%, because that amount is greater than the gross proceeds from the sale of the vehicle (\$300).

7.04 Sections 170(f)(12)(D) and 6720 inapplicable if donor claims deduction of \$500 or less

For contributions within the scope of the rules described in section 4 of this notice (regarding deductions of \$500 or less), §§ 170(f)(12)(D) and 6720 do not apply.

SECTION 8. EFFECTIVE DATE AND INTERIM GUIDANCE FOR DONORS AND DONEE ORGANIZATIONS

8.01 Effective date and transition rules

This notice generally is effective for contributions made on or after January 1, 2005. However, the following transition rules are provided. A contemporaneous written acknowledgment that is obtained on or before July 3, 2005, will be treated as satisfying the requirements of § 170(f)(12)(A) if the acknowledgment contains all of the information specified in § 170(f)(12)(B), even if the acknowledgment does not include the date the qualified vehicle is sold (as required by section 3.03(2) of this notice), or a detailed description of the intended significant intervening use or material improvement by the donee organization (as required by section 3.03(3) of this notice). In the case of contributions described in section 3.02(3) of this notice regarding qualified vehicles sold at a price significantly below fair market value (or gratuitously transferred) to needy individuals, the requirement of section 3.03(4) of this notice that an acknowledgment contain the information described in that section is effective for contributions made on or after January 1, 2005. For such contributions made on or before September 1, 2005, the acknowledgment must be obtained by the donor on or before October 1, 2005.

8.02 Extension of time to obtain acknowledgments under § 170(f)(12) for contributions made on or before September 1, 2005

Pursuant to § 170(f)(12)(F), the Service and the Treasury Department have determined that it is appropriate to provide donors an extension of time to obtain the contemporaneous written acknowledgment required by § 170(f)(12)(A). Therefore, for contributions made on or before September 1, 2005, a written acknowledgment will be considered contemporaneous for purposes of § 170(f)(12)(C) if it is obtained within the time specified in § 170(f)(12)(C) or, if later, on or before October 1, 2005.

8.03 Form of acknowledgment

A donee organization may provide an acknowledgment to a donor containing the information required under § 170(f)(12) in any reasonable manner. The Service and the Treasury Department will be providing Form 1098-C for reporting to the Service the information required to be reported under § 170(f)(12)(D). A copy of Form 1098-C may be used by a donee organization to provide a contemporaneous written acknowledgment to a donor pursuant to § 170(f)(12).

8.04 Satisfaction of contemporaneous requirement for purposes of § 6720

Section 6720 imposes penalties on any donee organization that knowingly fails to furnish an acknowledgment within the time required under § 170(f)(12) or the regulations thereunder. See section 7.03 of this notice. A donee organization that provides a contemporaneous written acknowledgment that is treated as contemporaneous under sections 8.01 and 8.02 of this notice will be treated as having furnished the acknowledgment within the time required under § 170(f)(12) for purposes of § 6720.

SECTION 9. REQUEST FOR COMMENTS

The Service and the Treasury Department invite comments regarding this notice and suggestions for future guidance under §§ 170(f)(12) and 6720. In particular, comments are requested on which markets are appropriate for measuring the fair

market value of vehicles for purposes of § 170, and for determining whether a sale was at a price significantly below fair market value for purposes of sections 3.02(3) and 7.01(3) of this notice. Commentators already have suggested that the most appropriate market for measuring the fair market value of vehicles is the market either for private party sales or for dealer trade-in transactions. Comments should address the factors that distinguish private party sales and dealer trade-in transactions, and which type of transaction is most similar to a charitable contribution. As discussed in section 5 of this notice, any regulations limiting the fair market value of a qualified vehicle for purposes of § 170 will not require use of a value less than the private party sale value for contributions made before the date the regulations become effective, but may require use of a value less than the private party sale value after that date. Comments should refer to Notice 2005-44 and be submitted by September 1, 2005, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044
Attn: CC:PA:LPD:PR
Room 5203

Alternatively, comments may be submitted electronically via e-mail to the following address: Notice.Comments@irs.counsel.treas.gov. All comments will be available for public inspection and copying.

SECTION 10. PAPERWORK REDUCTION ACT

The collections of information in this notice have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1942.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this notice are in sections 3, 4, 7, and 8. The collections of information in sections 3, 4, and 8 are required from donors to satisfy the substantiation requirements of

§ 170(f)(12). The collections of information are required from donors to obtain a benefit. The likely respondents are individual donors.

The collections of information in sections 3, 4, 7, and 8 are required from donee organizations to satisfy the donee reporting requirements of § 170(f)(12) and avoid the penalties in § 6720. The collections of information are mandatory. The likely respondents are tax-exempt charitable organizations.

The estimated total annual reporting burden is 3,041 hours for donors and 21,500 hours for donee organizations.

The estimated annual burden per donor varies from 1 minute to 5 minutes. The estimated annual burden per donee organization varies from 30 minutes to 16 hours, depending on individual circumstances. The estimated average annual burdens are

1 minute for donors and 5 hours for donee organizations. The estimated number of donors is 182,500 and the estimated number of donee organizations is 4,300.

The estimated annual frequency of responses (used for reporting requirements only) is annually.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by § 6103.

SECTION 11. DRAFTING INFORMATION

The principal author of this notice is Patricia M. Zweibel of the Office of Associate Chief Counsel (Income Tax &

Accounting). For information regarding whether a transfer is in direct furtherance of a donee organization's charitable purpose, contact Sean Barnett of the Tax Exempt and Government Entities Division at (202) 283-8913. For information regarding penalties under § 6720, contact Donnell Rini-Swyers of the Office of Associate Chief Counsel (Procedure and Administration) at (202) 622-4910. For information regarding information reporting by a donee organization, contact Mr. Barnett or Ms. Rini-Swyers. For further information regarding the remainder of this notice, contact Ms. Zweibel at (202) 622-5020 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Attained Age of the Insured Under Section 7702

REG-168892-03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations explaining how to determine the attained age of an insured for purposes of testing whether a contract qualifies as a life insurance contract for Federal income tax purposes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 24, 2005. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, September 14, 2005, must be received by August 24, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-168892-03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-168892-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or submitted to the IRS web site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-168892-03). All comments will be available for public inspection and copying. Requests to speak, with outlines of topics to be discussed, at the hearing scheduled for September 14, 2005, at 10 a.m., must be received by August 24,

2005. The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Ann H. Logan, 202-622-3970. Concerning submission of comments, the hearing, or to be placed on the building access list to attend the hearing, LaNita Van Dyke of the Publication and Regulations Branch, 202-622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 7702(a) of the Internal Revenue Code (Code) provides that, for a contract to qualify as a life insurance contract for Federal income tax purposes, the contract must be a life insurance contract under the applicable law and must either (1) satisfy the cash value accumulation test of section 7702(b), or (2) both meet the guideline premium requirements of section 7702(c) and fall within the cash value corridor of section 7702(d). To determine whether a contract satisfies the cash value accumulation test, or meets the guideline premium requirements and falls within the cash value corridor, it is necessary to determine the attained age of the insured.

A contract meets the cash value accumulation test of section 7702(b) if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. Under section 7702(e)(1)(B), the maturity date of the contract is deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100, for purposes of applying the cash value accumulation test.

A contract meets the guideline premium requirements of section 7702(c) if the sum of the premiums paid under the contract does not at any time exceed the greater of

the guideline single premium or the sum of the guideline level premiums as of such time. The guideline single premium is the premium that is needed at the time the policy is issued to fund the future benefits under the contract based on the following three elements enumerated in section 7702(c)(3)(B):

(i) Reasonable mortality charges that meet the requirements (if any) prescribed in regulations and that (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued;

(ii) Any reasonable charges (other than mortality charges) that (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid; and

(iii) Interest at the greater of an annual effective rate of six percent or the rate or rates guaranteed on issuance of the contract.

The guideline level premium is the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis but using a minimum interest rate of four percent, rather than six percent. Like the cash value accumulation test, the guideline premium requirements are applied by deeming the maturity date of the contract to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. The deemed maturity date generally is the determination date set forth in the contract or the end of the mortality table (which, when section 7702 was enacted in 1984, was age 100).

A contract falls within the cash value corridor if the death benefit of the contract at any time is not less than the applicable percentage of the cash surrender value. The applicable percentage is determined based on the attained age of the insured as of the beginning of the contract year, as follows:

APPLICABLE PERCENTAGE

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentage shall decrease by a ratable portion for each full year:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

The Code does not define the attained age of the insured for purposes of applying the cash value corridor, the guideline premium limitations, and the computational rules of section 7702(e). The Senate Finance Committee explanation of the Deficit Reduction Act of 1984, Public Law 98-369 (98 Stat. 494), however, states that the attained age of the insured means the insured's age determined by reference to contract anniversaries (rather than the individual's actual birthdays), so long as the age assumed under the contract is within 12 months of the actual age. See S. Prt. No. 98-169, Vol. 1, at 576 (1984).

Section 7702A defines a modified endowment contract as a contract that meets the requirements of section 7702 (that is, a contract that is a life insurance contract), but that fails to meet the 7-pay test set forth in section 7702A(b). A contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums that would have been paid on or before that time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums. Section 7702A(c)(1)(B) provides that, for purposes of this test, the computational rules of section 7702(e) generally apply, including the contract's deemed maturity no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100.

In sum, the attained age of an insured under a contract that is a life insurance contract under the applicable law must be determined to test whether the contract com-

plies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and (by reason of the computational rules of section 7702(e)) the cash value accumulation test of section 7702(b) and the 7-pay test of section 7702A(b), as applicable.

Discussion

Although most life insurance contracts insure the life of one person, some life insurance contracts insure multiple lives. For example, a last-to-die life insurance contract (sometimes referred to as a survivorship or second-to-die life insurance contract) insures two or more lives and pays death benefits when the last insured dies. Such contracts are sometimes used in connection with business continuation or estate tax planning; the contracts typically involve lower premiums than do contracts insuring a single life.

A first-to-die life insurance contract (sometimes referred to as a joint life insurance contract) also insures two or more lives, but pays death benefits and terminates upon the death of the first insured. These contracts typically involve higher risks and thus higher premiums than do contracts insuring a single life. First-to-die life insurance contracts represent a small percentage of the multiple-life insurance contracts that are issued.

Section 7702A, which defines the term *modified endowment contract* (MEC), incorporates the computational rules of section 7702, both in its initial determination of whether a contract is a life insurance contract, and in its 7-pay test calcu-

lations. Further, section 7702A(c)(6) provides a specific computational rule that applies to multiple life insurance contracts if the death benefit under the contract is reduced.

Neither section 7702, section 7702A, nor the legislative history of either provision, addresses how an insured's attained age is determined for purposes of testing a life insurance contract insuring multiple lives under the cash value accumulation test of section 7702(b), the guideline premium requirements of section 7702(c), or the computational rules of section 7702(e).

Explanation of Provision

This document contains proposed amendments to 26 CFR part 1 under section 7702. The proposed regulations provide guidance on how to determine the attained age of an insured individual under a contract that is a life insurance contract under the applicable law, for purposes of testing whether the contract qualifies as a life insurance contract under section 7702 and is a MEC under section 7702A. Under the proposed regulations, the attained age of the insured under a contract insuring the life of a single individual is either (i) the insured's age determined by reference to the individual's actual birthday as of the date of determination (actual age) or (ii) the insured's age determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the age assumed under the contract (contract age) is within 12 months of the actual age. The attained age of the insured under a contract insuring multiple lives on

a last-to-die basis is the attained age of the youngest insured. The attained age of the insured under a contract insuring multiple lives on a first-to-die basis is the attained age of the oldest insured. The Treasury Department and the IRS understand that the approach of the proposed regulations is consistent with the existing practice of many (but not all) issuers of both contracts insuring a single life and contracts insuring multiple lives. In addition, by mandating the use of a single, predictable age, the proposed regulations provide rules that are straightforward for both issuers and the IRS to administer.

The proposed regulations generally would be applicable for contracts issued on or after the date that is one year after the regulations are published as final regulations in the **Federal Register**. This applicability date recognizes that some issuers will need time to conform their compliance system to the proposed standard for the issuance of new contracts, to file policy forms with State authorities, or both. Taxpayers also would be permitted to apply the regulations retroactively for contracts issued before the date that is one year after the regulations are published as final regulations, provided they do not later determine qualification of those contracts under section 7702 in a manner inconsistent with the regulations.

The proposed regulations defining the attained age for purposes of these provisions are not intended to specify which multiple-life actuarial methodologies are appropriate to determine reasonable mortality charges under sections 7702 and 7702A, or how any such methodology should be applied.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking will be submitted

to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. In addition to comments on the proposed regulations more generally, the IRS and Treasury Department specifically request comments on (i) the clarity of the proposed regulations and how they can be made easier to understand, (ii) the industry's existing practice for determining the attained age to use under both last-to-die and first-to-die life insurance contracts, (iii) the need for special rules for determining the attained age of one or more insureds to calculate mortality charges under section 7702(c)(3)(B)(i), and (iv) the effective date of the proposed regulations. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 14, 2005, at 10 a.m., in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present a photo identification to enter the building. Because of access restrictions, visitors must use the Constitution Avenue entrance and will not be admitted beyond the Internal Revenue Building lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by August 24, 2005, and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by that same date.

A period of 10 minutes will be allotted to each person(s) for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed.

Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Ann H. Logan, Office of the Associate Chief Counsel (Financial Institutions and Products), Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.7702-3 also issued under 26 U.S.C. 7702(k). * * *

Par. 2. Section 1.7702-0, proposed to be added at 56 FR 30720 and published on July 15, 1991, and further proposed to be amended at 57 FR 59321 and published on December 15, 1992, is further proposed to be revised to read as follows:

§1.7702-0 Table of contents.

This section lists the captions that appear in §§1.7702-1, 1.7702-2, and 1.7702-3:

§1.7702-1 Mortality charges.

- (a) General rule.
- (b) Reasonable mortality charges.
 - (1) Actually expected to be imposed.
 - (2) Limit on charges.
- (c) Safe harbors.
 - (1) 1980 C.S.O. Basic Mortality Tables.
 - (2) Unisex tables and smoker/non-smoker tables.
 - (3) Certain contracts based on 1958 C.S.O. table.
- (d) Definitions.
 - (1) Prevailing commissioners' standard tables.
 - (2) Substandard risk.
 - (3) Nonparticipating contract.
 - (4) Charge reduction mechanism.
 - (5) Plan of insurance.

- (e) Effective date.

§1.7702-2 Definitions.

- (a) In general.
- (b) Cash value.
 - (1) In general.
 - (2) Amounts excluded from cash value.
- (c) Death benefit.
 - (1) In general.
 - (2) Qualified accelerated death benefit treated as death benefit.
- (d) Qualified accelerated death benefit.
 - (1) In general.
 - (2) Determination of present value of the reduction in death benefit.
 - (3) Examples.
- (e) Terminally ill defined.
- (f) Certain other additional benefits.
 - (1) In general.
 - (2) Examples.
- (g) Adjustments under section 7702(f)(7)
 - (h) Cash surrender value.
 - (1) In general.
 - (2) For purposes of section 7702(f)(7).
 - (i) Net surrender value.
 - (j) Effective date and special rules.
 - (1) In general.
 - (2) Provision of certain benefits before July 1, 1993.
 - (i) Not treated as cash value.
 - (ii) No effect on date of issuance.
 - (iii) Special rule for addition of benefit or loan provision after December 15, 1992.
 - (3) Addition of qualified accelerated death benefit.
 - (4) Addition of other additional benefits.

§1.7702-3 Attained age of the insured under a life insurance contract.

- (a) In general.
- (b) Contract insuring a single life.
- (c) Contract insuring multiple lives on a last-to-die basis.
- (d) Contract insuring multiple lives on a first-to-die basis.
- (e) Examples.
- (f) Effective dates.
 - (1) In general.
 - (2) Contracts issued before the general effective date.

Par. 3. Section 1.7702-3 is added to read as follows:

§1.7702-3 Attained age of the insured under a life insurance contract.

(a) *In general.* This section provides guidance on determining the attained age of an insured under a contract that is a life insurance contract under the applicable law, for purposes of testing whether the contract complies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and the computational rules of section 7702(e), as applicable.

(b) *Contract insuring a single life.* (1) If a contract insures the life of a single individual, either of the following two ages may be treated as the attained age of the insured with respect to that contract—

(i) The insured's age determined by reference to the individual's actual birthday as of the date of determination (actual age); or

(ii) The insured's age determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the age assumed under the contract (contract age) is within 12 months of the actual age.

(2) Whichever attained age is used with respect to a contract must be used consistently from year to year and consistently for purposes of sections 7702(c), 7702(d), and 7702(e), as applicable.

(c) *Contract insuring multiple lives on a last-to-die basis.* If a contract insures the lives of more than one individual on a last-to-die basis, the attained age of the insured is determined by applying paragraph (b) of this section as if the youngest individual were the only insured under the contract.

(d) *Contract insuring multiple lives on a first-to-die basis.* If a contract insures the lives of more than one individual on a first-to-die basis, the attained age of the insured is determined by applying paragraph (b) of this section as if the oldest individual were the only insured under the contract.

(e) *Examples.* The following examples illustrate the determination of the attained age of the insured for purposes of testing whether the contract complies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and the computational rules of section 7702(e), as applicable. The examples are as follows:

Example 1. (i) X was born on May 1, 1947. On January 1, 2008, X purchases from IC a contract in-

suring X's life. January 1 is the contract anniversary date for all future years. Under the contract, X's premiums are determined on an age-last-birthday basis. X became 60 years old on May 1, 2007. Based on the method used under the contract to determine age, X has an attained age of 60 for the first contract year, 61 for the second contract year, and so on.

(ii) Section 1.7702-3(b) provides that, if a contract insures the life of a single individual, the insured's age may be determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the contract age is within 12 months of the actual age. For each contract year, X's contract age, determined on an age-last-birthday basis, is within 12 months of X's actual age. Accordingly, provided it does so consistently from year to year, IC may compute X's attained age on an age-last-birthday basis for purposes of testing whether a contract complies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and the computational rules of section 7702(e), as applicable.

Example 2. (i) The facts are the same as in *Example 1* except that, under the contract, X's premiums are determined on an age-nearest-birthday basis. X's nearest birthday to January 1, 2008, is May 1, 2008, when X will become 61 years old. Based on the method used under the contract to determine age, X has an attained age of 61 for the first contract year, 62 for the second contract year, and so on.

(ii) Section 1.7702-3(b) provides that, if a life insurance contract insures the life of a single individual, the insured's age may be determined by reference to contract anniversary (rather than the individual's actual birthday), so long as the contract age is within 12 months of the actual age. For each contract year, X's contract age, determined on an age-nearest-birthday basis, is within 12 months of X's actual age. Accordingly, provided it does so consistently from year to year, IC may compute X's attained age on an age-nearest-birthday basis for purposes of testing whether the contract complies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and the computational rules of section 7702(e), as applicable.

Example 3. (i) The facts are the same as in *Example 1* except that in addition to X, the insurance contract also insures the life of Y. Y was born on September 1, 1942. The death benefit will be paid when the last of the two insureds dies.

(ii) Section 1.7702-3(c) provides that if a life insurance contract insures the lives of more than one individual on a last-to-die basis, the attained age of the insured is determined by applying §1.7702-3(b) as if the youngest individual were the only insured under the contract. Because X is younger than Y, the attained age of X must be used for purposes of testing whether the contract complies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and the computational rules of section 7702(e), as applicable. The attained ages of X and Y are determined as set forth in *Example 1*.

Example 4. (i) The facts are the same as *Example 1* except that in addition to X, the insurance contract also insures the life of Y. Y was born on September 1, 1952. The death benefit will be paid when the first of the two insureds dies.

(ii) Section 1.7702-3(d) provides that if a life insurance contract insures the lives of more than one individual on a first-to-die basis, the attained age of the insured is determined by applying §1.7702-3(b) as if the oldest individual were the only insured under the contract. Because X is older than Y, the attained age of X must be used for purposes of testing whether the contract complies with the guideline premium requirements of section 7702(c), the cash value corridor of section 7702(d), and the computational rules of section 7702(e), as applicable. The attained ages of X and Y are determined as set forth in *Example 1*.

(f) *Effective dates*—(1) *In general*. Except as provided in paragraph (f)(2), these regulations are effective for contracts issued on or after the date that is one year after the regulations are published as final regulations in the **Federal Register**.

(2) *Retroactive application*. Pursuant to section 7805(b)(7), a taxpayer may elect to apply these regulations retroactively for contracts issued before the date that is one year after the regulations are published as final regulations in the **Federal Register**, provided that the taxpayer does not later determine qualification of those contracts in a manner that is inconsistent with these regulations.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 24, 2005, 70 F.R. 29671)

Notice of Proposed Rulemaking and Notice of Public Hearing

Dual Consolidated Loss Regulations

REG-102144-04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 1503(d) of the Internal Revenue Code (Code) regarding dual consolidated losses. Section 1503(d) generally provides that a dual consolidated loss of a dual resident corporation cannot reduce the taxable income of

any other member of the affiliated group unless, to the extent provided in regulations, such loss does not offset the income of any foreign corporation. Similar rules apply to losses of separate units of domestic corporations. The proposed regulations address various dual consolidated loss issues, including exceptions to the general prohibition against using a dual consolidated loss to reduce the taxable income of any other member of the affiliated group.

DATES: Written and electronic comments and outlines of topics to be discussed at the public hearing scheduled for September 7, 2005, at 10:00 a.m., must be received by August 22, 2005.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-102144-04), room 5203, Internal Revenue Service, P.O. Box 7604, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-102144-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov/ (IRS and REG-102144-04). The public hearing will be held in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kathryn T. Holman, (202) 622-3840 (not a toll-free number); concerning submissions and the hearing, Robin Jones, (202) 622-3521 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 USC 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503,

with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by July 25, 2005. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in these proposed regulations are in §§1.1503(d)-1(b)(14), 1.1503(d)-1(c)(1), 1.1503(d)-2(d), 1.1503(d)-4(c)(2), 1.1503(d)-4(d), 1.1503(d)-4(e)(2), 1.1503(d)-4(f)(2), 1.1503(d)-4(g), 1.1503(d)-4(h) and 1.1503(d)-4(i). The various information is required. First, it notifies the IRS when the taxpayer asserts that it had reasonable cause for failing to comply with certain filing requirements under the regulations. Second, it indicates when the taxpayer attempts to rebut the amount of presumed tainted income. Finally, it provides the IRS various information regarding exceptions to the domestic use limitation, including domestic use elections, domestic use agreements, triggering events and recapture.

The collection of information is in certain cases required and in certain cases voluntary. The likely respondents will be domestic corporations with foreign operations that generate losses.

Estimated total annual reporting and/or recordkeeping burden: 2,665 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 1.5 hours.

Estimated number of respondents and/or recordkeepers: 1,765.

Estimated annual frequency of responses: Annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 USC 6103.

Background

The United States taxes the worldwide income of domestic corporations. A domestic corporation is a corporation created or organized in the United States or under the law of the United States or of any State. The United States allows certain domestic corporations to file consolidated returns with other affiliated domestic corporations. When two or more domestic corporations file a consolidated return, losses that one corporation incurs generally may reduce or eliminate tax on income that another corporation earns.

Some countries use criteria other than place of incorporation or organization to determine whether corporations are residents for tax purposes. For example, some countries treat corporations as residents for tax purposes if they are managed or controlled in that country. If one of these countries determines a corporation to be a resident, the corporation is generally subject to income tax of that foreign country on a residence basis. As a result, if such a corporation is a domestic corporation for U.S. tax purposes, it is a dual resident corporation and is subject to the income tax of both the foreign country and the United States on a residence basis.

Prior to the Tax Reform Act of 1986, if a corporation was a resident of both a foreign country and the United States, and the foreign country permitted the losses of the corporation to be used to offset the income of another person (for example, as a result of consolidation), then the dual resident corporation could use any losses it generated twice: once to offset income that was subject to U.S. tax, but not foreign tax, and a second time to offset income subject

to foreign tax, but not U.S. tax (double-dip).

Congress was concerned that this double-dip of a single economic loss could result in an undue tax advantage to certain foreign investors that made investments in domestic corporations, and could create an undue incentive for certain foreign corporations to acquire domestic corporations and for domestic corporations to acquire foreign rather than domestic assets. Staff of Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 1064 – 1065 (1987). Through such double-dipping, worldwide economic income could be rendered partially or fully exempt from current taxation. Moreover, even if the foreign income against which the loss was used would eventually be subject to U.S. tax (upon a repatriation of earnings), there were timing benefits of double dipping that the statute was intended to prevent. Congress responded to this concern by enacting section 1503(d) as part of the Tax Reform Act of 1986.

Section 1503(d) provides that a dual consolidated loss of a corporation cannot reduce the taxable income of any other member of the corporation's affiliated group. The statute defines a dual consolidated loss as a net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its income without regard to the source of its income, or is subject to tax on a residence basis. The statute authorizes the issuance of regulations permitting the use of a dual consolidated loss to offset the income of a domestic affiliate if the loss does not offset the income of a foreign corporation under foreign law.

Section 1503(d) further states that, to the extent provided in regulations, similar rules apply to any loss of a *separate unit* of a domestic corporation as if such unit were a wholly owned subsidiary of the corporation. Although the statute does not define the term *separate unit*, the legislative history to the provision refers to the loss of any separate and clearly identifiable unit of a trade or business of a taxpayer and cites as an example a foreign branch of a domestic corporation. See H.R. Rep. No. 795, 100th Cong., 2d Sess. July 26, 1988) at 293.

The IRS and Treasury issued temporary regulations under section 1503(d) in

1989 (T.D. 8261, 1989–2 C.B. 220). The temporary regulations generally provided that, unless one of three limited exceptions applied, a dual consolidated loss of a dual resident corporation could not offset the income of any other member of the dual resident corporation's affiliated group. The temporary regulations contained similar rules for losses incurred by separate units.

In response to comments that the temporary regulations were unnecessarily restrictive, the IRS and Treasury issued final regulations under section 1503(d) in 1992 (T.D. 8434, 1992–2 C.B. 240). These final regulations were updated and amended over the next 11 years (current regulations). The current regulations apply the section 1503(d) limitation more narrowly than the temporary regulations. The current regulations adopt an *actual use* standard for permitting a dual consolidated loss to offset income of members of the affiliated group. This standard, which applies to both dual resident corporations and separate units, requires taxpayers to certify that no portion of the dual consolidated loss has been or will be used to offset the income of any other person under the income tax laws of a foreign country. If such a certification is made and a subsequent *triggering event* occurs, the dual consolidated loss must be recaptured in the year of the event (plus an applicable interest charge).

This document proposes amendments to the current regulations under section 1503(d). Conforming amendments are also proposed to related regulations under sections 1502 and 6043.

Overview

In general, the proposed regulations address three fundamental concerns that arise in connection with the current regulations. First, the IRS and Treasury believe that the scope of application of the current regulations should be modified. For example, the current regulations may apply to certain structures where there is little likelihood of a double-dip. Moreover, the IRS and Treasury understand that some taxpayers have taken the position that the current regulations do not apply to certain structures that provide taxpayers the benefits of the type of double-dip that section 1503(d) is intended to deny. Accordingly, the proposed

regulations are designed to minimize these cases of potential over- and under-application.

Second, the IRS and Treasury recognize that there are many unresolved issues that arise when applying the current regulations, particularly in light of the adoption of the entity classification regulations under §§301.7701-1 through 301.7701-3. Thus, the proposed regulations modernize the dual consolidated loss regime to take into account the entity classification regulations and to resolve the related issues so that the rules can be applied by taxpayers and the Commissioner with greater certainty.

Finally, the IRS and Treasury believe that, in many cases, the current regulations are administratively burdensome to both taxpayers and the Commissioner. Accordingly, the proposed regulations reduce, to the extent possible, the administrative burden imposed on taxpayers and the Commissioner.

Explanation of Provisions

A. Structure of the Proposed Regulations

The proposed regulations are set forth in six sections. Section 1.1503(d)-1 contains definitions and special rules for filings. Section 1.1503(d)-2 sets forth operating rules, which include the general rule that prohibits the domestic use of a dual consolidated loss (subject to certain exceptions discussed below), a rule that limits the use of dual consolidated losses following certain transactions, an anti-avoidance provision that prevents dual consolidated losses from offsetting income from assets acquired in certain nonrecognition transactions or contributions to capital, and rules for computing foreign tax credit limitations. Section 1.1503(d)-3 contains special rules for accounting for dual consolidated losses. These special rules determine the amount of a dual consolidated loss, determine the effect of a dual consolidated loss on domestic affiliates, and provide special basis adjustments. Section 1.1503(d)-4 provides exceptions to the general rule that prohibits the domestic use of a dual consolidated loss, including a domestic use election. Section 1.1503(d)-5 contains examples that illustrate the application of the proposed regulations. Finally, §1.1503(d)-6 contains

the proposed effective date of the proposed regulations.

In addition to the proposed regulatory amendments under section 1503(d), the proposed regulations also include conforming proposed amendments to §1.1502-21 and §1.6043-4T.

B. Definitions and Special Rules for Filings under Section 1503(d) — §1.1503(d)-1

1. Treatment of a separate unit as a domestic corporation and a dual resident corporation

Section 1.1503-2(c)(3) and (4) of the current regulations defines a separate unit of a domestic corporation as a foreign branch, within the meaning of §1.367(a)-6T(g), (foreign branch separate unit) and an interest in a partnership, trust or hybrid entity. The current regulations also provide that any separate unit of a domestic corporation is treated as a separate domestic corporation for purposes of applying the dual consolidated loss rules. Section 1.1503-2(c)(2). In addition, the current regulations provide that, unless otherwise indicated, any reference to a dual resident corporation refers also to a separate unit. As a result of these rules, certain provisions of the current regulations only refer to dual resident corporations, and therefore apply to separate units because they are treated as domestic corporations and dual resident corporations. However, other provisions of the current regulations refer to both dual resident corporations and separate units (for example, see §1.1503-2(g)(2)(iii)(A)).

The IRS and Treasury believe that, in certain cases, treating separate units as domestic corporations creates uncertainty in applying the current regulations. This may occur, for example, as a result of certain rules applying to separate units because they are treated as domestic corporations or dual resident corporations, while other rules apply explicitly to separate units themselves. Accordingly, the proposed regulations do not contain a general rule that treats separate units as domestic corporations or dual resident corporations for all purposes of applying the dual consolidated loss regulations. Instead, the proposed regulations explicitly refer to dual resident corporations and separate

units where appropriate, treat separate units as domestic corporations only for limited purposes, and modify the operative rules where necessary to take into account differences between dual resident corporations and separate units.

2. Application of section 1503(d) to S corporations

Section 1.1503-2(c)(2) of the current regulations provides that an S corporation, as defined in section 1361, is not a dual resident corporation. The preamble to the current regulations explains that S corporations are so excluded because an S corporation cannot have a domestic corporation as one of its shareholders. The current regulations do not, however, explicitly exclude separate units owned by an S corporation from the definition of a dual resident corporation. As a result, the current regulations can be read to provide that an S corporation, although it cannot itself be a dual resident corporation, could own a separate unit that would be a dual resident corporation.

The IRS and Treasury believe that such a result is inappropriate because an S corporation cannot have a domestic corporation as one of its shareholders and generally is not taxable at the entity level. Accordingly, the proposed regulations provide that for purposes of the dual consolidated loss rules, an S corporation is not treated as a domestic corporation. This modification clarifies that the dual consolidated loss regulations do not apply to the S corporation itself, or to foreign branches or interests in certain flow-through entities owned by an S corporation.

The IRS and Treasury request comments as to whether regulated investment companies (as defined in section 851) or real estate investment trusts (as defined in section 856) should be similarly excluded from the application of the dual consolidated loss rules.

3. Losses of a foreign insurance company treated as a domestic corporation

Section 953(d) generally provides that a foreign corporation that would qualify to be taxed as an insurance company if it were a domestic corporation may, under certain circumstances, elect to be treated as a domestic corporation. Section

953(d)(3) provides that if a corporation elects to be treated as a domestic corporation pursuant to section 953(d) and is treated as a member of an affiliated group, any loss of such corporation is treated as a dual consolidated loss for purposes of section 1503(d), without regard to section 1503(d)(2)(B) (grant of regulatory authority to exclude losses which do not offset the income of foreign corporations from the definition of a dual consolidated loss). Therefore, losses of such corporations are treated as dual consolidated losses regardless of whether the corporation is subject to an income tax of a foreign country on its worldwide income or on a residence basis.

The current regulations do not address the application of section 953(d)(3). However, the definition of a dual resident corporation contained in the proposed regulations includes a foreign insurance company that makes an election to be treated as a domestic corporation pursuant to section 953(d) and is a member of an affiliated group, regardless of how such entity is taxed by the foreign country.

4. Definition of a separate unit

(a) Interests in Non-Hybrid Entity Partnerships and Interests in Non-Hybrid Entity Grantor Trusts

Section 1.1503-2(c)(4) of the current regulations defines a separate unit to include an interest in a hybrid entity (hybrid entity separate unit). The current regulations define a hybrid entity as an entity that is not taxable as an association for U.S. income tax purposes, 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. This definition includes an interest in such an entity that is treated for U.S. tax purposes as a partnership (hybrid entity partnership) or as a grantor trust (hybrid entity grantor trust). An interest in an entity that is treated as a partnership or a grantor trust for both U.S. and foreign tax purposes (non-hybrid entity partnership and non-hybrid entity grantor trust, respectively) also is treated as a separate unit under the current regulations. §1.1503-2(c)(3)(i).

The current regulations also apply to a separate unit owned indirectly through a partnership or grantor trust. Thus,

for example, if a partnership owns a foreign branch within the meaning of §1.367(a)-6T(g), a domestic corporate partner's interest in such partnership, and its indirect interest in a portion of the foreign branch owned through the partnership, each constitutes a separate unit.

Under the current regulations, an interest in a non-hybrid entity partnership or a non-hybrid entity grantor trust is also treated as a separate unit, regardless of whether the partnership or grantor trust has any nexus with a foreign jurisdiction. This rule can result in the application of the dual consolidated loss rules when there may be little opportunity for a double-dip. For example, if two domestic corporations each own 50 percent of a domestic partnership that generates losses attributable to activities conducted solely in the United States, the corporate partners would be technically subject to the dual consolidated loss rules and therefore would not be allowed to offset their income with such losses, unless an exception applied. In such a case, however, it may be unlikely that the losses would be available to offset income of another person under the income tax laws of a foreign country.

The IRS and Treasury believe that including an interest in a non-hybrid entity partnership and an interest in a non-hybrid entity grantor trust in the definition of a separate unit may not be necessary and is administratively burdensome. In such cases, it may be unlikely that deductions and losses solely attributable to activities of the partnership or grantor trust, that do not rise to the level of a taxable presence in a foreign jurisdiction, can be used to offset income of another person under the income tax laws of a foreign country. As a result, the proposed regulations eliminate from the definition of a separate unit an interest in a non-hybrid entity partnership and an interest in a non-hybrid entity grantor trust. It should be noted, however, that the proposed regulations retain the rule contained in the current regulations that a domestic corporation can own a separate unit indirectly through both hybrid entity and non-hybrid entity partnerships, and through both hybrid entity and non-hybrid entity grantor trusts.

(b) Separate Unit Combination Rule

Section 1.1503-2(c)(3)(ii) of the current regulations provides that if two or more foreign branches located in the same foreign country are owned by a single domestic corporation and the losses of each branch are made available to offset the income of the other branches under the tax laws of the foreign country, then the branches are treated as one separate unit. The combination rule in the current regulations does not apply to interests in hybrid entity separate units or to dual resident corporations.

Although a disregarded entity is treated as a branch of its owner for various purposes of the Code, the current regulations distinguish a hybrid entity separate unit that is disregarded as an entity separate from its owner from a foreign branch separate unit. Compare §1.1503-2(c)(3)(i)(A) and (c)(4); see also §1.1503-2(g)(2)(vi)(C). Accordingly, the combination rule under the current regulations does not apply to an interest in a hybrid entity separate unit, even if the hybrid entity is disregarded as an entity separate from its owner.

The combination rule in the current regulations also requires the foreign branches to be owned by a single domestic corporation. Thus, for example, the current regulations do not permit the combination of foreign branches owned by different domestic corporations, even if such corporations are members of the same consolidated group. In addition, in some cases the current regulations do not allow the combination of foreign branches that are owned indirectly by a single domestic corporation through other separate units because, as discussed above, such other separate units are generally treated as domestic corporations for purposes of applying the dual consolidated loss regulations. As a result, such foreign branches are not treated as being owned by a single domestic corporation.

The IRS and Treasury believe that the application of the combination rule should not be restricted to foreign branch separate units. In addition, the IRS and Treasury believe that the combination rule should not be limited to those cases where the domestic corporation owns the separate units directly. Therefore, provided certain requirements are satisfied, the proposed reg-

ulations adopt a broader combination rule that combines all separate units that are directly or indirectly owned by a single domestic corporation.

In order for separate units to be combined under the proposed regulations, the losses of each separate unit must be made available to offset the income of the other separate units under the tax laws of a single foreign country. In addition, if the separate unit is a foreign branch separate unit, it must be located in the foreign country that allows its losses to be made available to offset income of each separate unit; if the separate unit is a hybrid entity separate unit, the hybrid entity must be subject to tax in the foreign country that allows losses to be made available to each separate unit either on its worldwide income or on a residence basis.

The combination rule in the proposed regulations does not combine separate units owned by different domestic corporations, even if the domestic corporations are included in the same consolidated group. The IRS and Treasury believe this approach is consistent with section 1503(d)(3), which provides that, to the extent provided in regulations, a loss of a separate unit of a domestic corporation is subject to the dual consolidated loss rules as if it were a wholly owned subsidiary of such domestic corporation. In addition, the combination rule contained in the proposed regulations only applies to separate units and therefore does not apply to dual resident corporations.

The IRS and Treasury, however, request comments as to whether there is authority to expand the combination rule and, if so, whether the combination rule should be expanded to include separate units that are owned directly or indirectly by domestic corporations that are members of the same consolidated group. Similarly, comments are requested as to whether the combination rule should be extended to apply to dual resident corporations. Further, the IRS and Treasury request comments on the application of the operative provisions of the proposed regulations to combined separate units owned by different domestic corporations (for example, the SRLY limitation under §1.1503(d)-3(c)).

5. *Exception to the definition of a dual consolidated loss*

Section 1.1503-2(c)(5)(ii)(A) of the current regulations provides a very limited exception to the definition of a dual consolidated loss where the income tax laws of a foreign country do not permit the dual resident corporation to either: (1) use its losses, expenses, or deductions to offset the income of any other person in the same taxable year; or (2) carry over or carry back its losses, expenses, or deductions to be used, by any means, to offset the income of any other person in other taxable years. This exception only applies in rare and unusual cases where the income tax laws of the foreign country do not allow any portion of the dual consolidated loss to be used to offset income of another person under any circumstances.

The IRS and Treasury understand that some taxpayers have improperly interpreted this provision in a manner inconsistent with the policies of the dual consolidated loss rules. As a result, the proposed regulations eliminate this exception to the definition of a dual consolidated loss. As discussed below, however, the proposed regulations contain a new exception to the general rule restricting the use of a dual consolidated loss to offset income of a domestic affiliate. In general, this new exception applies when there is no possibility that any portion of the dual consolidated loss can be double-dipped, and operates in a manner that is similar to the manner in which the exception to the definition of a dual consolidated loss contained in the current regulations operates.

6. *Partnership special allocations*

Section 1.1503-2(c)(5)(iii) of the current regulations reserves on the treatment of dual consolidated losses of separate units that are partnership interests, including interests in hybrid entities. The preamble to the current regulations explains that the reservation was principally the result of concerns regarding partnership special allocations.

The proposed regulations no longer reserve on the treatment of separate units that are partnership interests. However, the IRS will continue to challenge structures that attempt to use special allocations in a

manner that is inconsistent with the principles of section 1503(d).

7. *Domestic use of a dual consolidated loss*

Section 1.1503-2(b)(1) of the current regulations states that, except as otherwise provided, a dual consolidated loss cannot offset the taxable income of any domestic affiliate, regardless of whether the loss offsets income of another person under the income tax laws of a foreign country, and regardless of whether the income that the loss may offset in the foreign country is, has been, or will be subject to tax in the United States. Section 1.1503-2(c)(13) defines the term domestic affiliate to mean any member of an affiliated group, without regard to exceptions contained in section 1504(b) (other than section 1504(b)(3)) relating to includible corporations.

The proposed regulations retain the general prohibition against using a dual consolidated loss to offset income of domestic affiliates contained in the current regulations, with modifications, and refer to such usage as a *domestic use* of a dual consolidated loss. This general prohibition is subject to a number of exceptions, discussed below. In addition, because the proposed regulations do not treat separate units as domestic corporations and dual resident corporations (other than for limited purposes) the proposed regulations expand the definition of a domestic affiliate to include separate units. This expanded definition is necessary for purposes of applying the domestic use limitation rule.

8. *Foreign use of a dual consolidated loss*

(a) *General Rule*

Section 1.1503-2T(g)(2)(i) of the current regulations provides that, in order to elect relief from the general limitation on the use of a dual consolidated loss to offset income of a domestic affiliate with respect to a dual consolidated loss ((g)(2)(i) election), the taxpayer must, among other things, certify that no portion of the losses, expenses, or deductions taken into account in computing the dual consolidated loss has been, or will be, used to offset the income of any other person under the income tax laws of a foreign country. If, contrary

to this certification, there is such a *use*, the dual consolidated loss subject to the (g)(2)(i) election generally must be recaptured and reported as gross income.

The IRS and Treasury understand that issues arise involving the application of the use rule contained in the current regulations. For example, issues may arise where items of income, gain, deduction and loss are treated as being generated or incurred by different persons under U.S. and foreign law. Similarly, issues may arise due to different definitions of a *person* under U.S. and foreign law. These issues have become more prevalent since the adoption of the entity classification regulations under §§301.7701-1 through 301.7701-3.

The IRS and Treasury also understand that taxpayers have taken positions under the current regulations regarding the use of a dual consolidated loss that are inconsistent with the policies underlying section 1503(d). On the other hand, the IRS and Treasury believe that, under the current regulations, a use can be deemed to occur in certain cases where there may be little likelihood of the type of double-dip that section 1503(d) was intended to prevent.

For the reasons discussed above, the proposed regulations modify the definition of *use* and provide a rule based on *foreign use*. These modifications are intended to minimize the potential over- and under-application of the dual consolidated loss rules that can occur under the current regulations. Under the proposed regulations, the foreign use definition is intended to minimize the opportunity for a double-dip. However, the new definition is also intended to minimize the situations in which a foreign use will occur in cases where there may be little likelihood of a double-dip.

The proposed regulations provide that a foreign use is deemed to occur only if two conditions are satisfied. The first condition is satisfied if any portion of a loss or deduction taken into account in computing the dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws (including items of income or gain generated by the dual resident corporation or separate unit itself), regardless of whether income or gain is actually offset, and regardless of

whether such items are recognized under U.S. tax principles. This condition ensures that there will not be a foreign use unless all or a portion of the dual consolidated loss offsets or reduces, or is made available to offset or reduce, income or gain for foreign tax purposes.

The second condition is satisfied if items that are (or could be) offset pursuant to the first condition are considered, under U.S. tax principles, to be items of: (1) a foreign corporation; or (2) a direct or indirect (for example, through a partnership) owner of an interest in a hybrid entity, provided such interest is not a separate unit. This condition is intended to limit a foreign use to situations where the foreign income that is (or could be) offset by the dual consolidated loss is not currently subject to U.S. corporate income tax. In general, if the foreign income that is offset is currently subject to U.S. corporate income tax, there is no double-dip of the dual consolidated loss.

(b) Exception to Foreign Use if no Dilution of an Interest in a Separate Unit

Section 1.1503-2(c)(15) of the current regulations employs a so-called *actual use* standard for determining whether there has been a use of a dual consolidated loss to offset the income of another person under the laws of a foreign country. Although referred to as an *actual use* standard, this rule provides that a use is considered to occur in the year in which a loss, expense or deduction taken into account in computing the dual consolidated loss is made available for such an offset, unless an exception applies. 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.

The *available* component of the actual use standard was adopted because of the administrative complexity that would result from having a use occur only when income is actually offset. For example, if in the year that a portion of the dual consolidated loss is made available to be used by another person, the other person itself generates a loss (or has a loss carryover), then in many cases the portion of the dual consolidated loss would become part of the loss carryover. Such loss therefore would be available to be carried forward or carried back to offset income in different tax-

able years. Under this approach, the portion of the loss carryforward or carryback that was taken into account in computing the dual consolidated loss would need to be identified and tracked, which would require detailed ordering rules for determining when such losses were used. Timing and base differences between the U.S. and foreign jurisdiction would further complicate such an approach.

Because of the administrative complexities discussed above, the foreign use definition contained in the proposed regulations retains the available for use standard. However, because the available for use standard is retained, there are many cases in which a foreign use of a dual consolidated loss attributable to interests in hybrid entity partnerships and hybrid entity grantor trusts, and separate units owned indirectly through partnerships and grantor trusts, occurs, even though no portion of any item of deduction or loss comprising the dual consolidated loss is double-dipped. In the case of interests in hybrid entity partnerships and hybrid entity grantor trusts, a portion of the dual consolidated loss attributable to an interest in such entity in many cases would be made available to offset income or gain of a direct or indirect owner of an interest in such hybrid entity, provided such interest is not a separate unit. This typically would occur because under foreign law the hybrid entity is taxed as a corporation (or otherwise at the entity level) and its net losses may be carried forward or carried back. A similar result may occur in the case of a separate unit owned indirectly through a non-hybrid entity partnership or a non-hybrid entity grantor trust because of timing and base differences between the laws of the United States and the foreign jurisdiction.

The IRS and Treasury believe this is an inappropriate result in many cases. For example, the IRS and Treasury believe that if there is no dilution of the domestic owner's interest in the separate unit, it is unlikely that any portion of the dual consolidated loss attributable to such separate unit can be put to a foreign use (other than through an election to consolidate or similar method, discussed below). Therefore, the proposed regulations include three new exceptions to the definition of a foreign use where there is no dilution of an interest in a separate unit. The new excep-

tions to foreign use apply to dual consolidated losses attributable to two types of separate units: (1) interests in hybrid entity partnerships and interests in hybrid entity grantor trusts; and (2) separate units owned indirectly through partnerships and grantor trusts.

The first exception to foreign use provides that, in general, no foreign use shall be considered to occur with respect to a dual consolidated loss attributable to an interest in a hybrid entity partnership or a hybrid entity grantor trust, solely because an item of deduction or loss taken into account in computing such dual consolidated loss is made available, under the income tax laws of a foreign country, to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and is considered under U.S. tax principles to be an item of the direct or indirect owner of an interest in such hybrid entity that is not a separate unit.

The second exception to foreign use provides that, in general, no foreign use shall be considered to occur with respect to a dual consolidated loss attributable to or taken into account by a separate unit owned indirectly through a partnership or grantor trust solely because an item of deduction or loss taken into account in computing such dual consolidated loss is made available, under the income tax laws of a foreign country, to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and is considered under U.S. tax principles to be an item of a direct or indirect owner of an interest in such partnership or trust.

Finally, the proposed regulations provide a similar exception for combined separate units that include individual separate units to which one of the other dilution exceptions would apply, but for the separate unit combination rule.

The new exceptions to foreign use are subject to certain limitations, however. First, the exceptions will not apply if there has been a dilution of the interest in the separate unit. That is, the exception will not apply if during any taxable year the domestic owner's percentage interest in the separate unit, as compared to its interest in the separate unit as of the last day of the taxable year in which such dual consolidated loss was incurred, is reduced as a result of another person acquiring through sale, exchange, contribution or

other means an interest in such partnership or grantor trust, unless the taxpayer demonstrates, to the satisfaction of the Commissioner, that the other person that acquired the interest in the partnership or grantor trust was a domestic corporation. The exceptions to foreign use should not apply when a person (other than a domestic corporation) acquires an interest in the separate unit because the dilution would typically result in an actual foreign use.

Second, the exceptions do not apply if the availability does not arise solely from the ownership in such partnership or trust and the allocation of the item of deduction or loss, or the offsetting by such deduction or loss, of an item of income or gain of the partnership or trust. For example, the exception does not apply in the case where the item of loss or deduction is made available through a foreign consolidation regime.

The IRS and Treasury request comments on the issues discussed above in connection with the availability component of the foreign use definition. Comments are specifically requested as to whether the dilution rules are appropriate and, if so, whether a *de minimis* exception should be provided.

9. *Mirror legislation rule*

Section 1.1503-2(c)(15)(iv) of the current regulations contains a *mirror legislation rule* that addresses legislation enacted by foreign jurisdictions that operates in a manner similar to the dual consolidated loss rules. This rule was designed to prevent the revenue gain resulting from the disallowance of the double-dip benefit of a dual consolidated loss from inuring solely to the foreign jurisdiction (to the detriment of the United States). Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1065-66 (J. Comm. Print 1987).

Congress recognized that mirror legislation in a foreign jurisdiction, in conjunction with a mirror legislation rule such as that contained in the current regulations, could result in the disallowance of a dual consolidated loss in both the United States and in the foreign jurisdiction. In such a case, Congress intended that Treasury pursue with the appropriate authorities in the foreign jurisdiction a bilateral agreement that would allow the use of the loss of a

dual resident corporation to offset income of an affiliate in only one country. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1066. The mirror rule was specifically held to be valid by the Court of Appeals for the Federal Circuit. *British Car Auctions, Inc. v. United States*, 35 Fed. Cl. 123 (1996), *aff'd without op.*, 116 F.3d 1497 (Fed. Cir. 1997).

The mirror legislation rule contained in the current regulations provides that if the laws of a foreign country deny the use of a loss of a dual resident corporation (or separate unit) to offset the income of another person because the dual resident corporation (or separate unit) is also subject to tax by another country on its worldwide income or on a residence basis, the loss is deemed to be used against the income of another person in such foreign country such that no (g)(2)(i) election can be made with respect to such loss. This rule is intended to prevent the foreign jurisdiction from enacting legislation that gives taxpayers no choice but to use the dual consolidated loss to offset income in the United States. This result is contrary to the general policy underlying the structure of the current regulations that provides taxpayers the choice of using the dual consolidated loss to either offset income in the United States or income in the foreign jurisdiction (but not both).

As a result of the consistency rule (discussed below), the deemed use of a dual consolidated loss pursuant to the mirror legislation rule may also restrict the ability to use other dual consolidated losses to offset the income of domestic affiliates, even if such losses are not subject to the mirror legislation.

Subsequent to the issuance of the current regulations, several foreign jurisdictions enacted various forms of mirror legislation that, absent the mirror legislation rule, would have the effect of forcing certain taxpayers to use dual consolidated losses to offset income of domestic affiliates.

Given the relevant legislative history and *British Car Auctions*, the IRS and Treasury believe that the mirror legislation rule remains necessary. This is particularly true in light of the prevalence of mirror legislation in foreign jurisdictions. As a result, the proposed regulations retain the mirror legislation rule. The proposed

regulations modify the mirror legislation rule, however, to address its proper application with respect to mirror legislation enacted subsequent to the issuance of the current regulations, and to modify its application to better take into account the policies underlying the consistency rule.

In general, the mirror legislation rule contained in the proposed regulations applies when the opportunity for a foreign use is denied because: (1) the loss is incurred by a dual resident corporation that is subject to income taxation by another country on its worldwide income or on a residence basis; (2) the loss may be available to offset income other than income of the dual resident corporation or separate unit under the laws of another country; or (3) the deductibility of any portion of a loss or deduction taken into account in computing the dual consolidated loss depends on whether such amount is deductible under the laws of another country.

The IRS and Treasury understand that there may be uncertainty as to the application of the mirror legislation rule in a given case when the mirror legislation is limited in its application. Mirror legislation may or may not apply to a particular dual resident corporation or separate unit depending on various factors, including the type of entity or structure that generates the loss, the ownership of the operation or entity that generates the loss, the manner in which the operation or entity is taxed in another jurisdiction, or the ability of the losses to be deducted in another jurisdiction. As a result, the proposed regulations clarify that the mere existence of mirror legislation, regardless of whether it applies to the particular dual resident corporation, may not result in a deemed foreign use. For example, see §1.1503(d)-5(c) *Example 23*.

The proposed regulations also clarify that the absence of an affiliate in the foreign jurisdiction, or the failure to make an election to enable a foreign use, does not prevent the opportunity for a foreign use. Thus, for example, the mirror legislation rule may apply even if there are no affiliates of the dual resident corporation in the foreign jurisdiction or, even where there is such an affiliate, no election is made to consolidate.

As discussed below, the consistency rule is intended to promote uniformity and reduce administrative burdens. The IRS

and Treasury believe that these concerns may not be significant, however, where there is only a deemed foreign use of a dual consolidated loss as a result of the mirror legislation rule. Accordingly, the mirror legislation rule contained in the proposed regulations provides that a deemed foreign use is not treated as a foreign use for purposes of applying the consistency rule.

10. Reasonable cause exception

The current regulations require various filings to be included on a timely filed tax return. In addition, taxpayers that fail to include such filings on a timely filed tax return must request an extension of time to file under §301.9100-3.

The IRS and Treasury believe that requiring taxpayers to request relief for an extension of time to file under §301.9100-3 results in an unnecessary administrative burden on both taxpayers and the Commissioner. The IRS and Treasury believe that a reasonable cause standard, similar to that used in other international provisions of the Code (such as sections 367(a) and 6038B), is a more appropriate and less burdensome means for taxpayers to cure compliance defects under section 1503(d). As a result, the proposed regulations adopt a reasonable cause standard. Moreover, extensions of time under §301.9100-3 will not be granted for filings under these proposed regulations. See §301.9100-1(d).

Under the reasonable cause standard, if a person that is permitted or required to file an election, agreement, statement, rebuttal, computation, or other information under the regulations fails to make such a filing in a timely manner, such person shall be considered to have satisfied the timeliness requirement with respect to such filing if the person is able to demonstrate, to the satisfaction of the Director of Field Operations having jurisdiction of the taxpayer's tax return for the taxable year, that such failure was due to reasonable cause and not willful neglect. Once the person becomes aware of the failure, the person must make this demonstration and comply by attaching all the necessary filings to an amended tax return (that amends the tax return to which the filings should have been attached), and including a written statement explaining the reasons for the failure to comply.

In determining whether the taxpayer has reasonable cause, the Director of Field Operations shall consider whether the taxpayer acted reasonably and in good faith. Whether the taxpayer acted reasonably and in good faith will be determined after considering all the facts and circumstances. The Director of Field Operations shall notify the person in writing within 120 days of the filing if it is determined that the failure to comply was not due to reasonable cause, or if additional time will be needed to make such determination.

C. Operating Rules — §1.1503(d)-2

1. Application of rules to multiple tiers of separate units

Section 1.1503-2(b)(3) of the current regulations provides that if a separate unit of a domestic corporation is owned indirectly through another separate unit, limitations on the dual consolidated losses of the separate units apply as if the upper-tier separate unit were a subsidiary of the domestic corporation, and the lower-tier separate unit were a lower-tier subsidiary. In light of changes made to other provisions of the proposed regulations, this rule is no longer necessary. As a result, the proposed regulations do not contain this provision.

2. Tainted income

Section 1.1503-2(e) of the current regulations prevents the dual consolidated loss of a dual resident corporation that ceases being a dual resident corporation from offsetting tainted income of such corporation. Subject to certain exceptions, tainted income is defined as income derived from assets that are acquired by a dual resident corporation in a nonrecognition transaction, or as a contribution to capital, at any time during the three taxable years immediately preceding the tax year in which the corporation ceases to be a dual resident corporation, or at any time thereafter. The current regulations also contain a rule that, absent proof to the contrary, presumes an amount of income generated during a taxable year as being tainted income. Such amount is the corporation's taxable income for the year multiplied by a fraction, the numerator of which is the fair market value of the tainted assets at the end of the year, and the denominator of which is the fair market

value of the total assets owned by each domestic corporation at the end of each year.

The tainted income rule is intended to prevent taxpayers from obtaining a double-dip with respect to a dual consolidated loss by stuffing assets into a dual resident corporation after, or in certain cases before, it terminates its status as a dual resident corporation. A double-dip may be obtained in such case because the income that offsets the dual consolidated loss generally would not be subject to tax in the foreign jurisdiction after the dual resident status of the corporation terminates.

The proposed regulations retain the tainted income rule, subject to the following modifications. The proposed regulations clarify that tainted income includes both income or gain recognized on the sale or other disposition of tainted assets and income derived as a result of holding tainted assets. The proposed regulations also modify the rule defining the amount of income presumed to be tainted income. The proposed regulations clarify that the presumptive rule only applies to income derived as a result of holding tainted assets; income or gain recognized on the sale or other disposition of tainted assets should be readily determinable such that the presumptive rule need not apply. The proposed regulations also provide that the numerator in the presumptive income fraction is the fair market value of tainted assets determined at the time such assets were acquired by the corporation, as opposed to being determined at the end of the taxable year. The IRS and Treasury believe that this approach is more administrable because value should be more readily determinable on the acquisition date. In addition, this approach does not require tainted assets to be traced over time.

D. Special Rules for Accounting for Dual Consolidated Losses — §1.1503(d)–3

1. Items attributable to a separate unit

(a) Overview

Section 1.1503–2(d)(1)(ii) of the current regulations provides a rule for determining whether a separate unit has a dual consolidated loss. Under this rule, the separate unit must compute its taxable income as if it were a separate domestic corpora-

tion that is a dual resident corporation, using only those items of income, expense, deduction, and loss that are *otherwise attributable* to such separate unit.

The current regulations do not provide any guidance for determining the items of income, gain, deduction and loss that are otherwise attributable to a separate unit. The IRS and Treasury understand that the absence of such guidance has resulted in considerable uncertainty. For example, commentators have questioned whether all or any portion of the interest expense of a domestic owner is attributable to a separate unit.

It is also unclear the extent to which a separate unit is treated as a separate domestic corporation under this rule. For example, commentators have questioned whether a transaction between a separate unit and its owner that is generally disregarded for federal tax purposes (for example, interest paid by a disregarded entity on an obligation held by its owner) can create an item of income, gain, deduction or loss for purposes of calculating a dual consolidated loss.

Commentators have also questioned whether each separate unit in a tiered separate unit structure (that is, where one separate unit owns another separate unit) must separately determine whether it has a dual consolidated loss, or whether such separate units are combined for this purpose.

The proposed regulations provide more definitive rules for determining the amount of a dual consolidated loss (or income) of a separate unit. These rules apply solely for purposes of section 1503(d) and, therefore, do not apply for other purposes of the Code (for example, section 987). The proposed regulations first provide general rules that apply for purposes of calculating dual consolidated losses (or income) for both foreign branch separate units and hybrid entity separate units. The proposed regulations provide additional rules for calculating the dual consolidated losses (or income) of foreign branch separate units, hybrid entity separate units, and separate units owned indirectly through other separate units, non-hybrid entity partnerships, or non-hybrid entity grantor trusts. Finally, the proposed regulations provide special rules that apply to tiered separate units, combined separate units, dispositions of

separate units, and the treatment of certain income inclusions on stock.

(b) General Rules

The proposed regulations clarify that only existing tax accounting items of income, gain, deduction and loss (translated into U.S. dollars) should be taken into account for purposes of calculating the dual consolidated loss of a separate unit. In other words, treating a separate unit as a separate domestic corporation does not cause items that are disregarded for U.S. tax purposes (for example, interest paid by a disregarded entity on an obligation held by its owner) to be regarded for purposes of calculating a separate unit's dual consolidated loss.

The proposed regulations also clarify that in the case of tiered separate units, each separate unit must calculate its own dual consolidated loss and no item of income, gain, deduction and loss may be taken into account in determining the taxable income or loss of more than one separate unit. Similarly, the proposed regulations clarify that items of one separate unit cannot offset or otherwise be taken into account by another separate unit for purposes of calculating a dual consolidated loss (unless the separate unit combination rule applies). These rules ensure that the dual consolidated loss calculation is computed separately for each separate unit, which is necessary to prevent deductions and losses from being double-dipped.

(c) Foreign Branch Separate Unit

The proposed regulations provide that the asset use and business activities principles of section 864(c) apply for purposes of determining the items of income, gain, deduction (other than interest) and loss that are taken into account in determining the taxable income or loss of a foreign branch separate unit. For this purpose, the trading safe harbors of section 864(b) do not apply for purposes of determining whether a trade or business exists within a foreign country or whether income may be treated as effectively connected to a foreign branch separate unit. In addition, the limitations on effectively connected treatment of foreign source related-party income under section 864(c)(4)(D) do not apply.

The proposed regulations further provide that the principles of §1.882-5, as modified, apply for purposes of determining the items of interest expense that are taken into account in determining the taxable income or loss of a foreign branch separate unit. The rules provide that a taxpayer must use U.S. tax principles to determine both the classification and amounts of the assets and liabilities when the actual worldwide ratio is used. The valuation of assets must be determined under the same methodology the taxpayer uses under §1.861-9T(g) for purposes of allocating and apportioning interest expense under section 864(e). Further, and solely for these purposes, the domestic owner of the foreign branch separate unit is treated as a foreign corporation, the foreign branch separate unit is treated as a trade or business within the United States, and assets other than those of the foreign branch separate unit are treated as assets that are not U.S. assets. Accordingly, only the interest expense of the domestic owner of the foreign branch separate unit is subject to allocation for purposes of computing the dual consolidated loss. The IRS and Treasury believe that the application of these principles will better harmonize the borrowing rate and effective interest costs that both the United States and the foreign country take into account in determining the dual consolidated loss, as compared to the use of §1.861-9T.

The IRS and Treasury believe that taking items into account in determining the taxable income or loss of a foreign branch separate unit under these standards is administrable because of the existing guidance provided under these provisions. In addition, the IRS and Treasury believe that this approach furthers the policy underlying section 1503(d) because it serves as a reasonable approximation of the items that the foreign jurisdiction may recognize as being taken into account in determining the taxable income or loss of a branch or permanent establishment of a non-resident corporation in such jurisdiction. Nevertheless, the IRS and Treasury solicit comments on these provisions and whether other administrable approaches (that approximate the items taken into account by the foreign jurisdiction) should be considered.

(d) *Hybrid Entity*

The proposed regulations provide rules for attributing items of income, gain, deduction and loss to a hybrid entity. These rules are necessary to determine the items that are attributable to an interest in a hybrid entity that constitutes a separate unit.

The proposed regulations provide that, in general, the items of income, gain, deduction and loss that are attributable to a hybrid entity are those items that are properly reflected on its books and records, as adjusted to conform to U.S. tax principles. The principles of §1.988-4(b)(2) apply for purposes of making this determination. These principles generally provide that the determination is a question of fact and must be consistently applied. These principles also provide that the Commissioner may allocate items of income, gain, deduction and loss between the domestic corporation (and intervening entities, if any) that own the hybrid entity separate unit, and the hybrid entity separate unit, if such items are not properly reflected on the books and records of the hybrid entity.

The proposed regulations also provide that if a hybrid entity owns an interest in either a non-hybrid entity partnership or a non-hybrid entity grantor trust, items of income, gain, deduction and loss that are properly reflected on the books and records of such partnership or grantor trust (under the principles of §1.988-4(b)(2), as adjusted to conform to U.S. tax principles), are treated as being properly reflected on the books and records of the hybrid entity. However, such items are treated as being properly reflected on the books and records of the hybrid entity only to the extent they are taken into account by the hybrid entity under principles of subchapter K, chapter 1 of the Code, or the principles of subpart E, subchapter J, chapter 1 of the Code, as the case may be.

The IRS and Treasury believe that attributing items to a hybrid entity under this standard is administrable because it is generally consistent with the accounting treatment of the items. The IRS and Treasury also believe that this standard furthers the policy underlying section 1503(d) because the items that are properly reflected on the books and records of the hybrid entity (as adjusted to conform to U.S. tax principles) represent the best approximation of items that the foreign jurisdiction would recog-

nize as being attributable to the entity. For example, it is likely that a foreign jurisdiction would recognize and take into account as being attributable to a hybrid entity the interest expense properly reflected on the books and records of the hybrid entity; however, it is unlikely that a foreign jurisdiction would recognize, and take into account as being attributable to a hybrid entity, interest expense of a domestic corporation that owns an interest in the hybrid entity.

(e) *Interest in a Disregarded Hybrid Entity*

The proposed regulations provide that, except to the extent otherwise provided under special rules (discussed below), items that are attributable to an interest in a hybrid entity that is disregarded as an entity separate from its owner are those items that are attributable to such hybrid entity itself.

(f) *Interests in Hybrid Entity Partnerships, Interests in Hybrid Entity Grantor Trusts, and Separate Units Owned Indirectly Through Partnerships and Grantor Trusts*

The proposed regulations provide rules for determining the extent to which: (1) items of income, gain, deduction and loss that are attributable to a hybrid entity that is a partnership are attributable to an interest in such hybrid entity partnership; and (2) items of income, gain, deduction and loss of a separate unit that is owned indirectly through a partnership are taken into account by a partner in such partnership. These items are taken into account to the extent they are includible in the partner's distributive share of the partnership income, gain, deduction or loss, as determined under the rules and principles of subchapter K, chapter 1 of the Code.

The proposed regulations also provide rules for determining the extent to which: (1) items of income, gain, deduction and loss attributable to a hybrid entity that is a grantor trust are attributable to an interest in such hybrid entity grantor trust; and (2) the items of income, gain, deduction and loss of a separate unit owned indirectly through a grantor trust are taken into account by an owner of such grantor trust. These items are taken into account to the extent they are attributable to trust property that the holder of the trust interest is treated as owning under the rules and prin-

principles of subpart E, subchapter J, chapter 1 of the Code.

(g) Allocation of Items Between Certain Indirectly Owned Separate Units

The proposed regulations provide special rules for allocating items of income, gain, deduction and loss to foreign branch separate units that are owned, directly or indirectly (other than through a hybrid entity separate unit) by hybrid entities. In such a case, only items that are attributable to the hybrid entity that owns such separate unit (and intervening entities, if any, that are not themselves separate units) are taken into account.

This rule is intended to minimize the items taken into account by a foreign branch separate unit that the foreign jurisdiction would not recognize as being so taken into account. This may occur in these cases because the foreign jurisdiction taxes the hybrid entity as a corporation (or otherwise at the entity level) and therefore likely would not take into account items of its owner. For example, if a domestic corporation indirectly owns a Country X foreign branch separate unit through a Country Y hybrid entity, Country X likely would take into account items of the Country Y hybrid entity as being items of the Country X branch. It is unlikely, however, that Country X would take into account items of the domestic corporation as items of the Country X branch because Country X views the owner of the Country X branch (the Country Y hybrid entity) as a corporation. Therefore, only the items of income, gain, deduction and loss of the Country Y hybrid entity (and not items of the domestic corporation) should be taken into account for purposes of determining the dual consolidated loss of the Country X branch.

The proposed regulations also provide that only income and assets of such hybrid entity are taken into account for purposes of applying the principles of section 864(c) and §1.882-5, as modified, in determining the items taken into account by the foreign branch separate unit; thus, other income and assets of the domestic owner, for example, are not taken into account for these purposes. This rule is also intended to ensure that the principles under these provisions are applied in a way that best approximates the items that the foreign jurisdic-

tion would recognize as being taken into account by a taxable presence in such jurisdiction.

Finally, the proposed regulations provide that items generally attributable to an interest in a hybrid entity are not taken into account to the extent they are taken into account by a foreign branch separate unit owned, directly or indirectly (other than through a hybrid entity separate unit), by the hybrid entity. This rule prevents two or more separate units from taking into account the same item of income, gain, deduction or loss under different rules.

(h) Combined Separate Units

As discussed above, the proposed regulations combine separate units owned, directly or indirectly, by a single domestic corporation, provided certain requirements are satisfied. Because different rules may apply for purposes of attributing items to individual separate units that may be combined into a single separate unit, special rules are necessary to attribute items to combined separate units.

The proposed regulations provide that in the case of a combined separate unit, items are first attributable to, or otherwise taken into account by, the individual separate units composing the combined separate unit, without regard to the combination rule. The combined separate unit then takes into account all of the items attributable to, or taken into account by, the individual separate units that compose such combined separate unit.

(i) Gain or Loss Recognized on Dispositions of Separate Units

The current regulations do not indicate whether items of income, gain, deduction and loss recognized on the sale or disposition of a separate unit, or of an interest in a partnership or grantor trust through which a separate unit is indirectly owned, is attributable to or taken into account by such separate unit for purposes of calculating the dual consolidated loss of the separate unit for the year of the sale (or for purposes of reducing the amount of recapture as a result of a triggering event).

The IRS and Treasury believe that it is appropriate to take into account items of income, gain, deduction and loss recognized on these dispositions. Thus, the proposed regulations provide that items of in-

come, gain, deduction and loss recognized on the disposition of a separate unit (or an interest in a partnership or grantor trust that directly or indirectly owns a separate unit), are attributable to or taken into account by the separate unit to the extent of the gain or loss that would have been recognized had such separate unit sold all its assets in a taxable exchange, immediately before the disposition of the separate unit, for an amount equal to their fair market value. The proposed regulations clarify that for this purpose items of income and gain include loss recapture income or gain under section 367(a)(3)(C) or 904(f)(3).

The proposed regulations also address situations where more than one separate unit is disposed of in the same transaction and items of income, gain, deduction and loss recognized on such disposition are attributable to more than one separate unit. In such a case, items of income, gain, deduction and loss are attributable to or taken into account by each such separate unit based on the gain or loss that would have been recognized by each separate unit if it had sold all of its assets in a taxable exchange, immediately before the disposition of the separate unit, for an amount equal to their fair market value.

(j) Income Inclusion on Stock

The current regulations do not indicate whether an amount included in income arising from the ownership of stock in a foreign corporation (income inclusion) is attributable to or taken into account by a separate unit that owns the stock that gave rise to the income inclusion. For example, if a domestic corporation has a section 951(a) inclusion attributable to stock of a controlled foreign corporation that is owned by a hybrid entity separate unit, it is not clear under the current regulations whether such income inclusion is taken into account for purposes of calculating the dual consolidated loss of the hybrid entity separate unit.

The IRS and Treasury believe that, solely for purposes of applying the dual consolidated loss rules, it is appropriate to treat income inclusions arising from the ownership of stock in the same manner that dividend income is treated. Accordingly, the proposed regulations provide that income inclusions are taken into account for purposes of calculating the dual

consolidated loss of a separate unit if an actual dividend from such foreign corporation would have been so taken into account.

(k) Section 987 Gain or Loss

Section 987 provides that if a taxpayer has one or more qualified business units with a functional currency other than the dollar, the taxpayer must make proper adjustments to take into account foreign currency gain or loss on certain transfers of property between such qualified business units.

In 1991, the IRS and Treasury issued proposed regulations under section 987 that included rules for determining the amount of foreign currency gain or loss recognized on certain transfers of property between qualified business units. On April 3, 2000, the IRS and Treasury issued Notice 2000-20, 2000-14 I.R.B. 851, announcing that the IRS and Treasury intend to review and possibly replace the proposed regulations issued under section 987. The IRS and Treasury have opened a regulations project under section 987 and expect to issue new section 987 regulations in the future.

The current regulations do not provide specific rules that indicate whether section 987 gains or losses of a domestic owner are attributable to, or taken into account by, a separate unit for purposes of calculating the separate unit's dual consolidated loss. Because the IRS and Treasury have an open regulations project under section 987 and expect to issue new regulations under section 987, the IRS and Treasury do not believe it is appropriate to address this issue in the proposed regulations. The IRS and Treasury request comments on whether section 987 gains and losses of a domestic owner should be attributable to, or taken into account by, a separate unit, particularly with respect to section 987 gains and losses attributable to, or taken into account by, separate units owned indirectly through hybrid entity separate units.

2. Effect of a dual consolidated loss

Section 1.1503-2(d)(2) of the current regulations provides that if a dual resident corporation has a dual consolidated loss that is subject to the general rule restricting it from offsetting the income of a domestic

affiliate, the consolidated group of which the dual resident corporation is a member must compute its taxable income without taking into account the items of income, gain, deduction or loss taken into account in computing the dual consolidated loss. The current regulations contain a similar rule for separate units.

These rules do not exclude only the dual consolidated loss in computing taxable income, but instead provide that none of the gross tax accounting items that compose the dual consolidated loss are taken into account. While this approach has the same effect on net income as would excluding only the dual consolidated loss, removing all gross items of income, gain, deduction and loss may have a distortive effect on other federal tax calculations.

The IRS and Treasury believe that this distortive effect will be minimized if only the dual consolidated loss itself is not taken into account. Accordingly, the proposed regulations provide that only a *pro rata* portion of each item of deduction and loss taken into account in computing the dual consolidated loss are excluded in computing taxable income. In addition, to the extent that a dual consolidated loss is carried over or carried back and, subject to §1.1502-21(c) (as modified in the proposed regulations), is made available to offset income generated by the dual resident corporation or separate unit, the proposed regulations treat items composing the dual consolidated loss as being used on a *pro rata* basis.

3. Basis adjustments

Section 1.1503-2(d)(3) of the current regulations contains special basis adjustment rules that override the normal investment adjustment rules under §1.1502-32 for stock of affiliated dual resident corporations or affiliated domestic owners owned by other members of the consolidated group. These rules provide that stock basis is reduced by a dual consolidated loss, even though such loss is subject to the general limitation on the use of a dual consolidated loss to offset income of a domestic affiliate. To avoid reducing the stock basis a second time for the same dual consolidated loss, the rules also provide that no negative adjustment shall be made for the amount of dual consolidated loss subject to the general

limitation that is subsequently absorbed in a carryover or carryback year. Finally, the rules provide that there is no basis increase for recapture income recognized as a result of a triggering event. Similar rules apply to separate units arising from ownership of an interest in a partnership. These special basis adjustment rules are generally intended to prevent an indirect deduction of a dual consolidated loss.

The proposed regulations retain the special stock basis adjustment rules, as modified, to prevent the indirect use of a dual consolidated loss. In addition, the proposed regulations retain the rules addressing the effect of a dual consolidated loss on a partner's adjusted basis in its partnership interest in cases where the partnership interest is a separate unit, or a separate unit is owned indirectly through a partnership. These rules require the partner to adjust its basis in accordance with the principles of section 705, subject to certain modifications.

The IRS and Treasury recognize that these rules may lead to harsh results, particularly in light of the fact that the indirect use of the dual consolidated loss would only arise through the disposition of the stock of a dual resident corporation (or a partnership interest) that may not occur for many years after the dual consolidated loss is incurred. In addition, upon such subsequent disposition the resulting deduction or loss would generally be capital in nature, and the definition of a dual consolidated loss excludes capital losses incurred by the dual resident corporation or separate unit. As a result, the IRS and Treasury request comments regarding concerns over these types of indirect uses and whether the special basis rules should be retained. These comments should consider whether the policies underlying section 1503(d) require basis adjustment rules that differ from other basis adjustment rules that apply to non-capital, non-deductible expenses (for example, rules under sections 705 and 1367, and §1.1502-32(b))

E. Exceptions to the Domestic Use Limitation Rule — §1.1503(d)-4

1. No possibility of foreign use

The proposed regulations provide a new exception to the general rule prohibiting

the domestic use of a dual consolidated loss. To qualify under this exception, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must: (1) demonstrate, to the satisfaction of the Commissioner, that there can be no foreign use of the dual consolidated loss at any time; and (2) prepare a statement and attach it to its tax return for the taxable year in which the dual consolidated loss is incurred. This statement must include an analysis, in reasonable detail and specificity, supported with an official or certified English translation of the relevant provisions of foreign law, of the treatment of the losses and deductions composing the dual consolidated loss, and the reasons supporting the conclusion that there cannot be a foreign use of the dual consolidated loss by any means at any time.

This exception is intended to replace the exception to the definition of a dual consolidated loss contained in §1.1503-2(c)(5)(ii)(A) of the current regulations. Thus, under the proposed regulations the question of foreign use is not relevant to the definition of a dual consolidated loss; the issue will instead be whether an exception to the domestic use limitation applies. Consistent with the exception to the definition of a dual consolidated loss contained in the current regulations, the IRS and Treasury believe that this new exception to the domestic use limitation rule contained in the proposed regulations will apply only in rare and unusual circumstances due to the definition of foreign use and general principles of foreign law. For example, if the foreign jurisdiction recognizes any item of deduction or loss composing the dual consolidated loss (regardless of whether recognized currently or deferred, for example, by being reflected in the basis of assets), and such item is available for foreign use through a form of consolidation, carryover or carryback, or a transaction (for example, a merger, basis carryover transaction, or entity classification election), then the exception will not apply.

2. Domestic use election and agreement

As discussed above, the current regulations provide an exception to the general rule prohibiting the use of a dual consolidated loss to offset the income of a domestic affiliate if a (g)(2)(i) election is made.

Under this exception, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner must enter into an agreement ((g)(2)(i) agreement) certifying, among other things, that no portion of the deductions or losses taken into account in computing the dual consolidated loss have been, or will be, used to offset the income of any other person under the income tax laws of a foreign country.

The proposed regulations retain this elective exception, with modifications, and refer to it as a *domestic use election*. In addition, the proposed regulations refer to the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, that makes a domestic use election as an *elector*. In order to elect relief under this exception, the proposed regulations require the elector to enter into a domestic use agreement, which is similar to the (g)(2)(i) agreement required by the current regulations.

3. Certification period

Under the current regulations, a (g)(2)(i) agreement generally provides that if there is a triggering event during the 15-year period following the year in which the dual consolidated loss was incurred (certification period), the taxpayer must recapture and report as income the amount of the dual consolidated loss, and pay an interest charge. See §1.1503-2(g)(2)(iii)(A).

Commentators have questioned whether under the current regulations the 15-year certification period applies only to the use triggering event, or whether it applies to all triggering events. These commentators note that, under this interpretation, triggering events other than use could occur after the expiration of the certification period. The IRS and Treasury believe that the certification period applies to all triggering events. Accordingly, the proposed regulations clarify that all triggering events are subject to the certification period and, therefore, a triggering event cannot occur after the expiration of the certification period.

The IRS and Treasury also believe that a 15-year certification period is not required to deter and monitor double-dipping of losses and deductions. Moreover,

the IRS and Treasury believe that requiring taxpayers to comply with the dual consolidated loss regulations, including the need to monitor potential triggering events and to comply with the various filing requirements, for a 15-year period is unnecessarily burdensome to both taxpayers and the Commissioner. As a result, the proposed regulations reduce the certification period from 15 years to seven years with respect to a domestic use election.

4. Consistency rule

Section 1.1503-2(g)(2)(ii) of the current regulations contains a consistency rule. Under this rule, if any losses, expenses, or deductions taken into account in computing the dual consolidated loss of a dual resident corporation or separate unit are used to offset the income of another person under the laws of a single foreign country while the dual resident corporation or separate unit is owned by the domestic owner or member of the consolidated group, the losses, expenses, or deductions taken into account in computing the dual consolidated losses of other dual resident corporations or separate units owned by the same consolidated group (or other separate units owned by the unaffiliated domestic owner of the first separate unit) in that year are deemed to offset income of another person in the same foreign country. This rule only applies, however, if such losses, expenses, or deductions are recognized in the foreign country in the same taxable year. Moreover, this rule does not apply if, under foreign law, the other dual resident corporation or separate unit cannot use its losses, expenses, or deductions to offset income of another person in such taxable year.

The consistency rule is intended to ensure that a consolidated group or domestic owner treats uniformly all dual consolidated losses of dual resident corporations or separate units that it owns that are available for use in a foreign country in a given year. The rule is also intended to minimize the administrative burden associated with identifying the items of loss or deduction of a particular dual consolidated loss that are used to offset income of another person under the income tax laws of a foreign country.

Commentators have questioned the need for the consistency rule, noting that it can lead to harsh results.

The IRS and Treasury believe that, despite concerns raised by commentators, the consistency rule continues to be necessary to promote the uniform treatment of dual consolidated losses of dual resident corporations and separate units owned by the consolidated group or domestic owner, and to minimize administrative burdens. As a result, the proposed regulations retain the consistency rule, as modified.

In addition, the proposed regulations clarify that the consistency rule only applies to a dual consolidated loss that is subject to a domestic use agreement (other than a new domestic use agreement). In other words, the proposed regulations clarify that the consistency rule does not apply to a foreign use of a dual consolidated loss that occurs subsequent to a triggering event that terminates the domestic use agreement filed with respect to such dual consolidated loss.

5. *Restrictions on domestic use elections*

The current regulations do not explicitly address situations where a triggering event (discussed below) with respect to a dual consolidated loss occurs in the year in which the dual consolidated loss is incurred. The proposed regulations, however, make clear that a domestic use election cannot be made for a dual consolidated loss incurred in the same year in which a triggering event with respect to such loss occurs.

The current regulations also do not explicitly address the application of section 953(d)(3) (limiting losses of foreign insurance companies that elect to be treated as domestic corporations). The proposed regulations, however, provide that a foreign insurance company that has elected to be treated as a domestic corporation pursuant to section 953(d) may not make a domestic use election. This rule is consistent with section 953(d)(3), which broadly prohibits regulatory exceptions to the general prohibition on the domestic use of dual consolidated losses in such cases.

6. *Triggering events*

(a) *In General*

Section 1.1503-2(g)(2)(iii) of the current regulations provides rules relating to certain events which require the recapture of previously allowed dual consolidated losses. Under these rules, if a consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, makes a (g)(2)(i) election, the dual resident corporation or separate unit must recapture, and the consolidated group, unaffiliated dual resident corporation or unaffiliated domestic owner must report as income the amount of the dual consolidated loss (and pay an interest charge) if a triggering event occurs during the certification period. Taxpayers may, however, rebut these triggering events upon making certain showings to the satisfaction of the Commissioner.

The proposed regulations generally retain the triggering event rules contained in the proposed regulations, as modified, if a taxpayer makes a domestic use election.

(b) *Carryover of Losses, Deductions, and Basis*

Under the current regulations, certain asset transfers by a dual resident corporation that result, under the laws of a foreign country, in a carryover of losses, expenses, or deductions are triggering events. The current regulations contain a similar rule for such transfers by separate units. See §1.1503-2(g)(2)(iii)(A)(4) and (5).

The proposed regulations retain these triggering events, as modified, and combine them into a single triggering event. The proposed regulations also clarify that certain asset transfers that result in the carryover of basis in assets under the laws of a foreign country also qualify as triggering events. This is the case because asset basis generally will, at some point in the future, be converted into a loss or deduction as a result of the depreciation, amortization or disposition of the asset. Accordingly, under foreign law, a transaction that results in the carryover of asset basis generally has the same effect as a transaction that results in the carryover of losses or deductions and therefore should be treated similarly.

(c) *Disposition by a Separate Unit or Dual Resident Corporation of an Interest in a*

Separate Unit or Stock of a Dual Resident Corporation

The current regulations provide that certain sales or other dispositions of 50 percent or more of the assets of a separate unit or dual resident corporation are deemed to be triggering events. See §1.1503-2(g)(2)(iii)(A)(4) and (5). For this purpose, an interest in a separate unit and stock of a dual resident corporation are treated as assets of the separate unit or dual resident corporation. One commentator stated that, as a result of this rule, the disposition of an interest in one separate unit by another separate unit may inappropriately result in a triggering event for both separate units. Accordingly, the commentator suggested that the disposition of the interest in the lower-tier separate unit should not result in a triggering event with respect to dual consolidated losses of the separate unit that disposed of such interest.

The IRS and Treasury believe that the disposition of an interest in a lower-tier separate unit (or the shares of a dual resident corporation) by an upper-tier separate unit (or dual resident corporation) typically will not result in the carryover of the dual consolidated loss of the upper-tier separate unit (or dual resident corporation) under the laws of the foreign jurisdiction such that it could be put to a foreign use. Therefore, the proposed regulations provide that for purposes of determining whether 50 percent or more of the separate unit's or dual resident corporation's assets is disposed of, an interest in a separate unit and the stock of a dual resident corporation shall not be treated as assets of the separate unit or dual resident corporation making such disposition. The IRS and Treasury request comments as to other assets the disposition of which should be excluded from the 50 percent test under this triggering event.

(d) *Fifty Percent Threshold for Asset Transfer Triggering Events*

Section 1.1503-2(g)(2)(iii)(A)(7) of the current regulations provides that a triggering event occurs if, within a 12-month period, the domestic owner of a separate unit disposes of 50 percent or more (by voting power or value) of the interest in the separate unit that was owned by the domestic owner on the last day of the

taxable year in which the dual consolidated loss was incurred. As noted above, the current regulations also provide that a triggering event occurs if a domestic owner of a separate unit transfers assets of the separate unit in a transaction that results, under the laws of a foreign country, in a carryover of the separate unit's losses, expenses, or deductions. Section 1.1503-2(g)(2)(iii)(A)(5). Moreover, the current regulations deem such an asset transfer to be a triggering event if 50 percent or more of the separate unit's assets (measured by fair market value at the time of transfer) are disposed of within a 12-month period.

One commentator noted that the two triggering events discussed above operate differently in that any transfer of assets of a separate unit may constitute a triggering event, while the transfer of an interest in a separate unit constitutes a triggering event only if a 50 percent threshold is met.

The IRS and Treasury believe that these two triggering events should operate in a consistent manner. As a result, the proposed regulations provide that both the asset transfer triggering event and the separate unit interest transfer triggering event occur only if a 50 percent threshold is satisfied. It should be noted, however, that transfers of assets of a dual resident corporation or separate unit, and transfers of interests of separate units, in many cases will subsequently result in a foreign use triggering event, even though the 50 percent threshold for the asset transfer triggering event and the separate unit interest transfer triggering event are not satisfied. For example, if a domestic owner of an interest in a hybrid entity separate unit transfers 25 percent of its interest in the hybrid entity separate unit to a foreign corporation, all or a portion of a dual consolidated loss attributable to such separate unit in a prior year may be available to offset subsequent income of the owner of the transferred interest (that is not a separate unit after such transfer because it is held by a foreign corporation) and therefore may result in a foreign use triggering event.

(d) *S Corporation Conversion*

Under the current regulations, if either an affiliated dual resident corporation or an affiliated domestic owner that has filed a (g)(2)(i) agreement with respect to a dual

consolidated loss elects to be an S corporation pursuant to section 1362(a), such election results in a triggering event because it terminates the consolidated group and the affiliated dual resident corporation or affiliated domestic owner ceases to be a member of a consolidated group. See §1.1503-2(g)(2)(iii)(A)(2). The current regulations do not, however, address an election to be an S corporation by either an unaffiliated dual resident corporation or an unaffiliated domestic owner that has made a (g)(2)(i) election.

The IRS and Treasury believe that the election by an unaffiliated dual resident corporation or unaffiliated domestic owner to be an S corporation should be treated in the same manner as an election by an affiliated dual resident corporation or affiliated domestic owner that is a member of a consolidated group. Accordingly, the proposed regulations add as a new triggering event the election of either an unaffiliated dual resident corporation or unaffiliated domestic owner to be an S corporation.

(f) *Consolidated Group Remains in Existence*

As stated above, and subject to exceptions, the current regulations provide that a triggering event occurs with respect to a dual consolidated loss of an affiliated dual resident corporation or affiliated domestic owner if such dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group of which it was a member when the dual consolidated loss was incurred. The current regulations also provide that an affiliated dual resident corporation or affiliated domestic owner is considered to cease to be a member of a consolidated group if the consolidated group ceases to exist (group termination triggering event) because, for example, the common parent is no longer in existence. Section 1.1503-2(g)(2)(iii)(A)(2).

One commentator stated that language contained in Revenue Procedure 2000-42, 2000-2 C.B. 394, may imply that there is a group termination triggering event if the common parent of a consolidated group that made a (g)(2)(i) election ceases to exist, or is a party to a reverse acquisition, even though the consolidated group remains in existence. This interpretation

is contrary to the principles underlying the triggering events. Accordingly, the proposed regulations clarify that such transactions do not constitute group termination triggering events. See §1.1503(d)-5(c) *Example 47*.

7. *Rebuttal of triggering events*

Under the current regulations, taxpayers may rebut all but two of the triggering events such that there is no dual consolidated loss recapture (or related interest charge) as a result of a putative triggering event. In general, under the current regulations, a triggering event is rebutted if the taxpayer demonstrates to the satisfaction of the Commissioner that, depending on the triggering event, either: (1) the losses, expenses or deductions of the dual resident corporation (or separate unit) cannot be used to offset income of another person under the laws of a foreign country or; (2) the transfer of assets did not result in a carryover under foreign law of the losses, expenses, or deductions of the dual resident corporation (or separate unit) to the transferee of the assets. See §1.1503-2(g)(2)(iii)(A)(2) through (7). The policies underpinning the dual consolidated loss rules do not require recapture or an interest charge in such cases because there is no opportunity for any portion of the dual consolidated loss to be used to offset income of any other person under the income tax laws of a foreign country.

The rebuttal rules impose a standard of proof on taxpayers that in many cases is difficult and burdensome to meet, even though there may be little likelihood that any portion of the dual consolidated loss could be used to offset the income of any other person under the income tax laws of a foreign country. For example, demonstrating that no portion of the dual consolidated loss can be used by another person as a result of typical loss carryover transactions under foreign law may not satisfy the burden if there is some potential that any portion of losses or deductions composing the dual consolidated loss could be so used as a result of a transaction that is rare, commercially impractical, or not reasonably foreseeable. In addition, because there are often significant differences between U.S. and foreign law, ruling out the various types of transactions that under

U.S. law would allow all or a portion of the dual consolidated loss to be used by another person also may not be sufficient to rebut a triggering event.

Commentators have noted that under the current regulations it may not be possible to rebut certain triggering events if the tax basis of a single asset carries over to another person under foreign law, even though as a result of the transaction recognized losses and accrued deductions generally do not carry over to another person under foreign law. This is the case because the person that receives the carryover asset basis may at some point in the future enjoy the benefit of a loss or deduction as a result of the depreciation, amortization or disposition of the asset. As a result, the carryover of a nominal amount of asset tax basis causes the entire dual consolidated loss to be recaptured. Similar issues arise in connection with assumptions of liabilities that, for example, result in deductions for U.S. tax purposes on an accrual basis, but are deductible under the laws of the foreign jurisdiction at a later time when paid. This result is consistent with the *all or nothing* principle, discussed below.

The IRS and Treasury recognize that in some of these cases the use of a portion of a dual consolidated loss may be denied in both the United States and the foreign jurisdiction. Further, commentators have stated that denying a loss or deduction from offsetting income in both the United States and the foreign jurisdiction generally is inconsistent with the principles underlying section 1503(d) because the statute's purpose is to prevent the use of the same loss or deduction to offset income in multiple jurisdictions.

The proposed regulations retain the rebuttal standard contained in the current regulations, with modifications. Taxpayers may rebut a triggering event under the proposed regulations if it can be demonstrated, to the satisfaction of the Commissioner, that there can be no foreign use of the dual consolidated loss. In addition, unlike the current regulations that have different standards for different triggering events, the proposed regulations apply the same standard to all triggering events (other than a foreign use triggering event, which cannot be rebutted).

The IRS and Treasury believe that when the proposed regulations are finalized the number of transactions undertaken by tax-

payers that result in triggering events will be significantly reduced, as compared to the current regulations, because of the significant reduction in the term of the certification period. Nevertheless, the IRS and Treasury believe that the current rebuttal standard may exceed that required to address adequately the concern that all or a portion of a dual consolidated loss could be put to a foreign use. Moreover, the IRS and Treasury believe that more definitive and administrable rebuttal rules should be provided to assist taxpayers and the Commissioner in determining whether the triggering event has been rebutted, and to minimize situations where there is recapture of a dual consolidated loss even though it may be unlikely that a significant portion of the dual consolidated loss could be put to a foreign use. Therefore, it is anticipated that, prior to the finalization of these proposed regulations, a revenue procedure will be issued that will provide safe harbors whereby triggering events will be deemed to be rebutted if the taxpayer satisfies various conditions. The revenue procedure may be issued in proposed form and then made final contemporaneously with these regulations.

It is anticipated that the conditions contained in the revenue procedure would include the requirement that taxpayers demonstrate, to the satisfaction of the Commissioner, that there can be no foreign use of any significant portion of the dual consolidated loss as a result of certain enumerated transactions. It is also anticipated that the revenue procedure will address, and in some cases provide relief for, transactions that result in a *de minimis* carry over of asset basis under foreign law and are difficult or impossible to rebut under the current regulations. Finally, the revenue procedure may provide relief for triggering events resulting from the assumption of liabilities in connection with the acquisition of a trade or business as a result of liabilities incurred in the ordinary course of business being deductible at different times under U.S. law and the law of the foreign jurisdiction.

The IRS and Treasury request comments regarding the transactions that should be included in the revenue procedure, approaches to address basis carryover transactions and liabilities assumed in the ordinary course of business, and other ways to minimize the administrative

burden associated with rebutting the triggering events, while ensuring that there is little or no likelihood that a significant portion of the dual consolidated loss can be put to a foreign use.

8. *Triggering event exception for acquisition by an unaffiliated domestic corporation or a new consolidated group*

Section 1.1503-2(g)(2)(iv)(B)(I) of the current regulations provides that if certain requirements are satisfied, the following events do not constitute triggering events: (1) an affiliated dual resident corporation or affiliated domestic owner becomes an unaffiliated domestic corporation or a member of a new consolidated group (unless such transaction also qualifies under another exception); (2) assets of a dual resident corporation or a separate unit are acquired by an unaffiliated domestic corporation or a member of a new consolidated group; or (3) a domestic owner of a separate unit transfers its interest in the separate unit to an unaffiliated domestic corporation or to a member of a new consolidated group.

The first requirement necessary for this exception to apply is that the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner that made the (g)(2)(i) election, and the unaffiliated domestic corporation or new consolidated group must enter into a closing agreement with the IRS providing that both parties will be jointly and severally liable for the total amount of the recapture of the dual consolidated loss and interest charge upon a subsequent triggering event. Second, the unaffiliated domestic corporation or new consolidated group must agree to treat any potential recapture as unrealized built-in gain for purposes of section 384, subject to any applicable exceptions thereunder. Finally, the unaffiliated domestic corporation or new consolidated group must file with its timely filed income tax return for the year in which the event occurs a (g)(2)(i) agreement (new (g)(2)(i) agreement), whereby it assumes the same obligations with respect to the dual consolidated loss as the corporation or consolidated group that filed the original (g)(2)(i) agreement with respect to that loss.

On July 30, 2003, the IRS and Treasury issued final regulations (T.D. 9084, 2003-2 C.B. 742) (2003 regulations), pub-

lished in the **Federal Register** at 68 FR 44616, that limited the need for closing agreements to avoid triggering events to only those three transactions described above. The preamble to the 2003 regulations explained that in certain cases the requirement for a closing agreement resulted in an unnecessary administrative burden because the several liability imposed by §1.1502-6, in conjunction with the original (g)(2)(i) agreement and a new (g)(2)(i) agreement, provided for liability sufficiently comparable to that imposed under a closing agreement. Accordingly, the 2003 regulations provided that if a new (g)(2)(i) agreement is filed by the unaffiliated domestic corporation or new consolidated group, a closing agreement is not required in the following two instances: (1) an unaffiliated dual resident corporation or unaffiliated domestic owner that filed a (g)(2)(i) agreement becomes a member of a consolidated group; and (2) a consolidated group that filed a (g)(2)(i) agreement ceases to exist as a result of a transaction described in §1.1502-13(j)(5)(i) (unless a member of the terminating group, or successor-in-interest of such member, is not a member of the surviving group immediately after the terminating group ceases to exist).

The preamble to the 2003 regulations noted that the IRS and Treasury were continuing to consider other alternatives to further reduce the administrative and compliance burdens under section 1503(d). After further consideration, the IRS and Treasury believe that, as a result of various requirements contained in the proposed regulations, there are sufficient protections, independent of a closing agreement, in all cases in which a closing agreement is otherwise required under the current regulations. As a result, the proposed regulations eliminate the closing agreement requirement contained in the current regulations and provide an exception to triggering events in all such cases (subsequent elector events) if: (1) the unaffiliated domestic corporation or new consolidated group (subsequent elector) enters into a domestic use agreement (new domestic use agreement); and (2) the corporation or consolidated group that filed the original domestic use agreement (original elector) files a statement with its tax return for the year of the event.

Pursuant to the new domestic use agreement, the subsequent elector must: (1) agree to assume the same obligations with respect to the dual consolidated loss as the original elector had pursuant to its domestic use agreement; (2) agree to treat any potential recapture of the dual consolidated loss at issue as unrealized built-in gain pursuant to section 384, subject to any applicable exceptions thereunder; (3) agree to be subject to the successor elector rules, discussed below; and (4) identify the original elector (and subsequent electors, if any). Pursuant to the statement filed by the original elector, the original elector must agree to be subject to the subsequent elector rules and must identify the subsequent elector.

9. *Triggering event exception — private letter ruling and closing agreement option*

Under the current regulations, only specific triggering events can qualify for an exception as a result of the parties entering into a closing agreement. Therefore, the IRS will not consider entering into a closing agreement in other circumstances, even though the government's interests may be adequately protected in such circumstances such that recapture may not be necessary.

Although the proposed regulations eliminate the need for a closing agreement to qualify for an exception to triggering events, discussed above, the IRS and Treasury are considering whether in limited cases it may be appropriate for the Commissioner, in its sole discretion and subject to the taxpayer satisfying conditions specified by the Commissioner, to enter into closing agreements with taxpayers such that certain other events would not be triggering events. Comments are requested as to the specific and limited types of triggering events that may be suitable for this exception, taking into account the policies underlying section 1503(d), administrative burdens, and the general interests of the U.S. government.

10. *Annual certification reporting requirement*

Section 1.1503-2T(g)(2)(vi)(B) of the current regulations provides that if a (g)(2)(i) election is made with respect to a dual consolidated loss of a dual resident

corporation or a hybrid entity separate unit, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, must file with its tax return an annual certification during the certification period. This filing certifies that the losses or deductions that make up the dual consolidated loss have not been used to offset the income of another person under the tax laws of a foreign country. The filing also warrants that arrangements have been made to ensure that there will be no such use of the dual consolidated loss and that the taxpayer will be informed if any such use were to occur. The current regulations do not, however, require annual certifications for dual consolidated losses of foreign branch separate units.

The IRS and Treasury believe that annual certifications of dual consolidated losses improve taxpayer compliance with the dual consolidated loss rules and are beneficial to the Commissioner in monitoring such compliance. The IRS and Treasury also believe that foreign branch separate units, hybrid entity separate units, and dual resident corporations should, to the extent possible, be treated consistently to reduce complexity. As a result, the proposed regulations expand the annual certification requirement to include dual consolidated losses of foreign branch separate units. However, the reduction in the certification period from 15 years to seven years should substantially reduce the overall compliance burden of this requirement.

11. *Amount of recapture*

As stated above, under the current regulations a triggering event (other than a foreign use) generally can be rebutted only if no portion of the dual consolidated loss can be used by (or carries over to) another person under foreign law. See §1.1503-2(g)(2)(iii)(A)(2) through (7). Thus, if even a *de minimis* portion of the dual consolidated loss can be used by (or carries over to) another person, the triggering event cannot be rebutted. Similarly, §1.1503-2(g)(2)(vii)(A) of the current regulations provides that if a triggering event occurs, the entire dual consolidated loss subject to the (g)(2)(i) agreement (reduced by income earned subsequently by the dual resident corporation or separate unit) is recaptured and reported as income,

regardless of the amount of the dual consolidated loss used by the other person. Thus, even a *de minimis* foreign use will cause the entire amount of the dual consolidated loss to be recaptured and reported as income.

This so-called *all or nothing* principle is included in the current regulations primarily due to administrative concerns. In many cases, the exact amount of the dual consolidated loss that is used by another person cannot be readily determined. This inability is due, in part, to differences between U.S. and foreign law. For example, there may be temporary and permanent differences in the treatment of items of income, gain, deduction and loss. There may also be differences in loss carryover provisions. These concerns are exacerbated by the principle that certain deductions are fungible and, therefore, cannot easily be traced to a particular loss incurred in a particular year.

Commentators have noted that in some cases the *all or nothing* principle results in a disallowance of deductions in both the United States and the foreign jurisdiction. Nevertheless, the IRS and Treasury believe that making a precise determination as to the amount of the dual consolidated loss put to a foreign use would require the Commissioner and taxpayers to analyze foreign law in great detail and, in some cases, compare the treatment of items under foreign law with their treatment under U.S. law. Such an analysis, however, is inconsistent with the principle underlying the regulations that, to the extent possible, the Commissioner and taxpayers should not be required to analyze foreign law. Moreover, departing from the *all or nothing* principle would likely require detailed ordering, stacking, and tracing rules to determine the amount and nature of dual consolidated losses that are recaptured upon a use. Such rules would add considerable complexity to the regulations. As a result, the proposed regulations retain the *all or nothing* rule contained in the current regulations. However, the IRS and Treasury request comments regarding administrable alternatives to the *all or nothing* rule that would not involve substantial analyses of foreign law. For example, comments are requested as to whether a *pro rata* recapture rule with respect to dispositions of separate units would be consistent with the

general framework of the proposed regulations and would be administrable.

12. Subsequent elector rules

Neither the current regulations nor Rev. Proc. 2000-42, 2000-2 C.B. 394, explicitly address the consequences resulting from a triggering event (to which no exception applies) with respect to a dual consolidated loss that was not recaptured due to an earlier triggering event as a result of the parties entering into a closing agreement. In such a case, both parties are jointly and severally liable for the total amount of the recapture of the dual consolidated loss and interest charge resulting from such a subsequent triggering event. However, it is unclear which taxpayer must report the recapture income (and related interest charge) on its tax return upon the subsequent triggering event. In addition, there is little or no procedural guidance outlining how, pursuant to a closing agreement, the IRS would collect recapture tax and the related interest charge from the parties to the closing agreement.

Accordingly, the proposed regulations contain rules regarding subsequent electors. These rules apply when, subsequent to an event that is not a triggering event because the unaffiliated domestic corporation or new consolidated group enters into a new domestic use agreement and satisfies other requirements (excepted event), a triggering event occurs, and no exception applies to such event (subsequent triggering event). The proposed regulations also provide rules that apply in the case of multiple subsequent electors (when subsequent to an excepted event, another excepted event occurs).

The proposed regulations first provide that, except to the extent provided under the subsequent elector rules, the original elector (and in the case of multiple excepted events, any prior subsequent elector) is not subject to the general recapture and interest charge rules provided under the regulations. As a result, only the subsequent elector that owns the dual resident corporation or separate unit at the time of the subsequent triggering event is subject to the general recapture and interest charge rules.

The proposed regulations also provide that, upon a subsequent triggering event to which no exception applies, the sub-

sequent elector must calculate the recapture tax amount with respect to the dual consolidated loss subject to the new domestic use agreement and include it, along with an identification of the dual consolidated losses at issue and the original elector, on a statement attached to its tax return. The subsequent elector calculates the recapture tax amount based on a *with and without* calculation. The recapture tax amount equals the excess (if any) of the income tax liability of the subsequent elector for the taxable year of the subsequent triggering event, over the income tax liability of the subsequent elector for such taxable year computed by excluding the amount of recapture and related interest charge with respect to the dual consolidated losses at issue.

In addition, the proposed regulations provide rules regarding tax assessment and collection procedures. The proposed regulations provide that an assessment identifying an income tax liability of the subsequent elector is considered an assessment of the recapture tax amount where such amount is part of the income tax liability being assessed and the recapture tax amount is reflected in the statement attached to the subsequent elector's tax return. The recapture tax amount is considered to be properly assessed as an income tax liability of the original elector, and each prior subsequent elector, if any, on the same date the income tax liability of the subsequent elector was properly assessed. This liability is joint and several.

The proposed regulations also provide procedures pursuant to which any unpaid balance of the recapture tax amount may be collected from the original elector and the prior subsequent elector, if any. Such amounts may be collected from the original elector, and/or any prior subsequent elector, if each of the following conditions is satisfied: (1) the Commissioner has properly assessed the recapture amount; (2) the Commissioner has issued a notice and demand for payment of the recapture tax amount to the subsequent elector; (3) the subsequent elector has failed to pay all of the recapture tax amount by the date specified in such notice and demand; and (4) the Commissioner has issued a notice and demand for payment of the unpaid portion of the recapture tax amount to the original elector and prior subsequent electors, if any. If the subsequent elector's

income tax liability for a taxable period includes a recapture amount, and if such income tax liability is satisfied in part by payment, credit, or offset, such amount shall be allocated first to that portion of the income tax liability that is not attributable to the recapture tax amount, and then to that portion of the income tax liability that is attributable to the recapture tax amount.

Finally, the proposed regulations contain rules regarding the refund of an income tax liability that includes a recapture tax amount.

13. *Character and source of recapture income*

Section 1.1503-2(g)(2)(vii)(D) of the current regulations provides that recapture income is treated as ordinary income having the same source and falling within the same separate category under section 904 as the dual consolidated loss being recaptured. The current regulations do not, however, provide an explicit rule to identify the items that compose the dual consolidated loss. As a result, it is unclear under the current regulations how to determine the source and separate category of recapture income. In addition, the current regulations do not explicitly state how the recapture income is treated for purposes of the Code other than section 904.

The proposed regulations clarify that the character (to the extent consistent with the recapture income being ordinary income in all cases) and source of the recapture income is determined based on the character and source of a *pro rata* portion of the deductions that were taken into account in calculating the dual consolidated loss. As discussed above, the dual consolidated loss is composed of a *pro rata* portion of all items of deduction and loss that are taken into account in computing such dual consolidated loss. Moreover, the proposed regulations clarify that the determination of the character and source of such income is not limited to section 904, but applies for all purposes of the Code (for example, section 856(c)(2) and (3)).

Under the proposed regulations, the character and source of losses and deductions composing the dual consolidated loss should be identified during the year in which they are incurred, rather than the year in which they are ultimately used to offset income or gain. This approach

attempts to simplify the rules and make them more administrable, rather than providing comprehensive stacking, ordering, and tracing rules that track the ultimate use of such items, which would be complex.

14. *Failure to comply with recapture provisions*

Under the current regulations, if the taxpayer fails to comply with the recapture provisions upon the occurrence of a triggering event, the dual resident corporation or separate unit that incurred the dual consolidated loss (or successor-in-interest) is not eligible to enter into a (g)(2)(i) agreement with respect to any dual consolidated losses incurred in the five taxable years beginning with the taxable year in which recapture is required. The current regulations contain two exceptions to this rule that apply unless the triggering event is an actual use of the dual consolidated loss. Under the first exception, the rule does not apply if the failure to comply is due to reasonable cause. Under the second exception, the rule does not apply if the taxpayer unsuccessfully attempted to rebut the triggering event by timely filing a rebuttal statement with its tax return.

This provision is intended to encourage taxpayers to carefully monitor potential triggering events and properly comply with the recapture provisions upon the occurrence of a triggering event.

The IRS and Treasury believe that the failure to comply penalty contained in the current regulations often does not operate in a manner that encourages compliance with the dual consolidated loss regulations. For example, if a taxpayer sells a dual resident corporation to a third party that is treated as a triggering event, but the taxpayer fails to comply with the recapture rules, the rule contained in the current regulations prevents the purchaser of the dual resident corporation from entering into a (g)(2)(i) agreement with respect to dual consolidated losses of the dual resident corporation for five years; it does not adversely affect the taxpayer that failed to properly comply with the recapture provisions. As a result, the proposed regulations do not include this penalty provision.

Although the proposed regulations do not retain this penalty provision, the Commissioner may consider applying other applicable penalty provisions in appropriate

circumstances; for example, the Commissioner may consider applying the accuracy-related penalty of section 6662. In addition, the IRS and Treasury will continue to consider whether a penalty provision, similar to the one contained in the current regulations, is appropriate, especially in cases of repeated non-compliance.

F. *Effective Date — §1.1503(d)-6*

The proposed regulations are proposed to apply to dual consolidated losses incurred in taxable years beginning after the date that these proposed regulations are published as final regulations in the **Federal Register**.

The IRS and Treasury request comments on the application of the regulations, including comments as to whether the proposed regulations, when finalized, should contain an election that would allow taxpayers to apply all or a portion of the regulations retroactively. In addition, comments are requested as to possible transition rules that may apply, including the application of the proposed regulations, when finalized, to existing (g)(2)(i) agreements.

Effect on Other Documents

When these proposed regulations are adopted as final regulations, Rev. Proc. 2000-42, 2000-2 C.B. 394, will be obsolete with respect to dual consolidated losses incurred in taxable years beginning after the date that these proposed regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rule making is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that also have a foreign affiliate, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to

section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

A public hearing has been scheduled for September 7, 2005, at 10 a.m., in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors must enter at the main entrance, located at 1111 Constitution Avenue, NW. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topic to be discussed and time to be devoted to each topic (preferably a signed original and eight (8) copies) by August 22, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Kathryn T. Holman of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 USC 7805 * * *

§1.1503(d) also issued under 26 U.S.C. 953(d) and 26 U.S.C. 1502

Par. 2. In §1.1502–21, paragraph (c)(2)(v) is amended by removing the language "§1.1503–2" and adding "§§1.1503(d)–1 through 1.1503(d)–6" in its place.

Par. 3. New §§1.1503(d)–0 through 1.1503(d)–6 are added to read as follows:

§1.1503(d)–0 Table of contents.

This section lists the captions contained in §§1.1503(d)–1 through 1.1503(d)–6.

§1.1503(d)–1 Definitions and special rules for filings under section 1503(d).

- (a) In general.
- (b) Definitions.
 - (1) Domestic corporation.
 - (2) Dual resident corporation.
 - (3) Hybrid entity.
 - (4) Separate unit.
 - (i) In general.
 - (ii) Separate unit combination rule.
 - (iii) Indirectly.
 - (5) Dual consolidated loss.
 - (6) Subject to tax.
 - (7) Foreign country.
 - (8) Consolidated group.
 - (9) Domestic owner.
 - (10) Affiliated dual resident corporation and affiliated domestic owner.
 - (11) Unaffiliated dual resident corporation, unaffiliated domestic corporation, and unaffiliated domestic owner.
 - (12) Domestic affiliate.
 - (13) Domestic use.
 - (14) Foreign use.
 - (i) In general.
 - (ii) Available for use.
 - (iii) Exceptions.
 - (A) No election to enable foreign use.
 - (B) Presumed use where no foreign country rule for determining use.
 - (C) No dilution of an interest in a separate unit.

- (1) General rules.
 - (i) Interest in a hybrid entity partnership or hybrid entity grantor trust.
 - (ii) Indirectly owned separate units.
 - (iii) Combined separate unit.
- (2) Exceptions.

(i) Dilution of an interest in a separate unit.

(ii) Consolidation and other prohibited uses.

(iv) Ordering rules for determining the foreign use of losses.

(v) Mirror legislation rule.

(15) Grantor trust.

(c) Special rules for filings under section 1503(d).

(1) Reasonable cause exception.

(2) Signature requirement.

§1.1503(d)–2 Operating rules.

(a) In general.

(b) Limitation on domestic use of a dual consolidated loss.

(c) Elimination of a dual consolidated loss after certain transactions.

(1) General rules.

(i) Dual resident corporation.

(ii) Separate unit.

(A) General rule.

(B) Combined separate unit.

(2) Exceptions.

(i) Certain section 368(a)(1)(F) reorganizations.

(ii) Acquisition of a dual resident corporation by another dual resident corporation.

(iii) Acquisition of a separate unit by a domestic corporation.

(d) Special rule denying the use of a dual consolidated loss to offset tainted income.

(1) In general.

(2) Tainted income.

(i) Definition.

(ii) Income presumed to be derived from holding tainted assets.

(3) Tainted assets defined.

(4) Exceptions.

(e) Computation of foreign tax credit limitation.

§1.1503(d)–3 Special rules for accounting for dual consolidated losses.

(a) In general.

(b) Determination of amount of dual consolidated loss.

(1) Affiliated dual resident corporation.

(2) Separate unit.

(i) General rules.

(ii) Foreign branch separate unit.

(A) In general.

(B) Principles of §1.882–5.

- (iii) Hybrid entity.
 - (A) General rule.
 - (B) Interest in a non-hybrid partnership and a non-hybrid grantor trust.
- (iv) Interest in a disregarded hybrid entity.
- (v) Items attributable to an interest in a hybrid entity partnership and a separate unit owned indirectly through a partnership.
- (vi) Items attributable to an interest in a hybrid entity grantor trust and a separate unit owned indirectly through a grantor trust.
 - (vii) Special rules.
 - (A) Allocation of items between certain tiered separate units.
 - (B) Combined separate unit.
 - (C) Gain or loss on the direct or indirect disposition of a separate unit.
 - (D) Income inclusion on stock.
- (3) Foreign tax treatment disregarded.
- (4) Items generated or incurred while a dual resident corporation or a separate unit.
 - (c) Effect of a dual consolidated loss on a domestic affiliate.
 - (1) Dual resident corporation.
 - (2) Separate unit.
 - (3) SRLY limitation.
 - (4) Items of a dual consolidated loss used in other taxable years.
 - (d) Special basis adjustments.
 - (1) Affiliated dual resident corporation or affiliated domestic owner.
 - (i) Dual consolidated loss subject to domestic use limitation.
 - (ii) Dual consolidated loss absorbed in carryover or carryback year.
 - (iii) Recapture income.
 - (2) Interests in hybrid entities that are partnerships or interests in partnerships through which a separate unit is owned indirectly.
 - (i) Scope.
 - (ii) Determination of basis of partner's interest.
 - (A) Dual consolidated loss subject to domestic use limitation.
 - (B) Dual consolidated loss absorbed in carryover or carryback year.
 - (C) Recapture income.
 - (3) Examples.

§1.1503(d)-4 Exceptions to the domestic use limitation rule.

- (a) In general.

- (b) Elective agreement in place between the United States and a foreign country.
 - (c) No possibility of foreign use.
 - (1) In general.
 - (2) Statement.
 - (d) Domestic use election.
 - (1) In general.
 - (2) Consistency rule.
 - (3) Restrictions on domestic use election.
 - (i) Triggering event in year of dual consolidated loss.
 - (ii) Losses of a foreign insurance company treated as a domestic corporation.
 - (e) Triggering events requiring the recapture of a dual consolidated loss.
 - (1) Events.
 - (i) Foreign use.
 - (ii) Disaffiliation.
 - (iii) Affiliation.
 - (iv) Transfer of assets.
 - (v) Transfer of an interest in a separate unit.
 - (vi) Conversion to a foreign corporation.
 - (vii) Conversion to an S corporation.
 - (viii) Failure to certify.
 - (2) Rebuttal.
 - (f) Exceptions.
 - (1) Acquisition by a member of the consolidated group.
 - (2) Acquisition by an unaffiliated domestic corporation or a new consolidated group.
 - (i) Subsequent elector events.
 - (ii) Non-subsequent elector events.
 - (iii) Requirements.
 - (A) New domestic use agreement.
 - (B) Statement filed by original elector.
 - (3) Subsequent triggering events.
 - (g) Annual certification reporting requirement.
 - (h) Recapture of dual consolidated loss and interest charge.
 - (1) Presumptive rules.
 - (i) Amount of recapture.
 - (ii) Interest charge.
 - (2) Reduction of presumptive recapture amount and presumptive interest charge.
 - (i) Amount of recapture.
 - (ii) Interest charge.
 - (3) Rules regarding subsequent electors.
 - (i) In general.
 - (ii) Original elector and prior subsequent electors not subject to recapture or interest charge.

- (iii) Recapture tax amount and required statement.
 - (A) In general.
 - (B) Recapture tax amount.
 - (iv) Tax assessment and collection procedures.
 - (A) In general.
 - (1) Subsequent elector.
 - (2) Original elector and prior subsequent electors.
 - (B) Collection from original elector and prior subsequent electors; joint and several liability.
 - (C) Allocation of partial payments of tax.
 - (D) Refund.
 - (v) Definition of income tax liability.
 - (vi) Example.
 - (4) Computation of taxable income in year of recapture.
 - (i) Presumptive rule.
 - (ii) Rebuttal of presumptive rule.
 - (5) Character and source of recapture income.
 - (6) Reconstituted net operating loss.
 - (i) Termination of domestic use agreement and annual certifications.
 - (1) Rebuttal of triggering event.
 - (2) Exception to triggering event.
 - (3) Recapture of dual consolidated loss.
 - (4) Termination of ability for foreign use.
 - (i) In general.
 - (ii) Statement.

§1.1503(d)-5 Examples.

- (a) In general.
- (b) Presumed facts for examples.
- (c) Examples.

§1.1503(d)-6 Effective date.

§1.1503(d)-1 Definitions and special rules for filings under section 1503(d).

(a) *In general.* This section and §§1.1503(d)-2 through 1.1503(d)-6 provide general rules concerning the determination and use of dual consolidated losses pursuant to section 1503(d). This section provides definitions that apply for purposes of this section and §§1.1503(d)-2 through 1.1503(d)-6. This section also provides a reasonable cause exception and a signature requirement for filings under this section and §§1.1503(d)-2 through 1.1503(d)-4.

(b) *Definitions.* The following definitions apply for purposes of this section and §§1.1503(d)–2 through 1.1503(d)–6:

(1) *Domestic corporation.* The term *domestic corporation* means an entity classified as a domestic corporation under section 7701(a)(3) and (4) or otherwise treated as a domestic corporation by the Internal Revenue Code, including, but not limited to, sections 269B, 953(d), and 1504(d). However, solely for purposes of Section 1503(d), the term domestic corporation does not include an S corporation, as defined in section 1361.

(2) *Dual resident corporation.* The term *dual resident corporation* means a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a residence basis. A corporation is taxed on a residence basis if it is taxed as a resident under the laws of the foreign country. The term *dual resident corporation* also means a foreign insurance company that makes an election to be treated as a domestic corporation pursuant to section 953(d) and is treated as a member of an affiliated group for purposes of chapter 6, even if such company is not subject to an income tax of a foreign country on its worldwide income or on a residence basis. See section 953(d)(3).

(3) *Hybrid entity.* The term *hybrid entity* means an entity that is not taxable as an association for U.S. income tax purposes but is subject to an income tax of a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.

(4) *Separate unit*—(i) *In general.* The term *separate unit* means either of the following that is owned, directly or indirectly, by a domestic corporation—

(A) A foreign branch, as defined in §1.367(a)–6T(g) (foreign branch separate unit); or

(B) An interest in a hybrid entity (hybrid entity separate unit).

(ii) *Separate unit combination rule.* If two or more separate units (individual separate units) are owned, directly or indirectly, by a single domestic corporation, and the losses of each individual separate unit are made available to offset the income of the other individual separate units under the income tax laws of a single foreign country, then such individual separate units shall be treated as one separate unit (combined separate unit), provided that—

(A) If the individual separate unit is a foreign branch separate unit, it is located in such foreign country; and

(B) If the individual separate unit is a hybrid entity separate unit, the hybrid entity (an interest in which is the hybrid entity separate unit) is subject to an income tax of such foreign country either on its worldwide income or on a residence basis. See §1.1503(d)–5(c) *Example 1*.

(iii) *Indirectly.* The term *indirectly*, when used in reference to ownership of a separate unit, means ownership through a separate unit, through an entity classified as a partnership under §§301.7701–1 through –3 of this chapter, or through a grantor trust (as defined in paragraph (b)(15) of this section), regardless of whether the partnership or grantor trust is a U.S. person.

(5) *Dual consolidated loss.* The term *dual consolidated loss* means—

(i) In the case of a dual resident corporation, the net operating loss (as defined in section 172(c) and the regulations thereunder) incurred in a year in which the corporation is a dual resident corporation; and

(ii) In the case of a separate unit, the net loss attributable to, or taken into account by, the separate unit under §1.1503(d)–3(b)(2).

(6) *Subject to tax.* For purposes of determining whether a domestic corporation or hybrid entity is subject to an income tax of a foreign country on its income, the fact that it has no actual income tax liability to the foreign country for a particular taxable year shall not be taken into account.

(7) *Foreign country.* The term *foreign country* includes any possession of the United States.

(8) *Consolidated group.* The term *consolidated group* means a consolidated group, as defined in §1.1502–1(h), that includes either a dual resident corporation or a domestic owner.

(9) *Domestic owner.* The term *domestic owner* means a domestic corporation that owns, directly or indirectly, one or more separate units.

(10) *Affiliated dual resident corporation and affiliated domestic owner.* The terms *affiliated dual resident corporation* and *affiliated domestic owner* mean a dual resident corporation and a domestic owner, respectively, that is a member of a consolidated group.

(11) *Unaffiliated dual resident corporation, unaffiliated domestic corporation, and unaffiliated domestic owner.* The terms *unaffiliated dual resident corporation*, *unaffiliated domestic corporation*, and *unaffiliated domestic owner* mean a dual resident corporation, domestic corporation, and domestic owner, respectively, that is not a member of a consolidated group.

(12) *Domestic affiliate.* The term *domestic affiliate* means—

(i) A member of an affiliated group, without regard to the exceptions contained in section 1504(b) (other than section 1504(b)(3)) relating to includible corporations;

(ii) A domestic owner; or

(iii) A separate unit.

(13) *Domestic use.* A *domestic use* of a dual consolidated loss shall be deemed to occur when the dual consolidated loss is made available to offset, directly or indirectly, the taxable income of any domestic affiliate of the dual resident corporation or separate unit (that incurred the dual consolidated loss) in the taxable year in which the dual consolidated loss is recognized, or in any other taxable year, regardless of whether the dual consolidated loss offsets income under the income tax laws of a foreign country and regardless of whether any income that the dual consolidated loss may offset in the foreign country is, has been, or will be subject to tax in the United States. A domestic use shall be deemed to occur in the year the dual consolidated loss is included in the computation of the taxable income of a consolidated group or an unaffiliated domestic owner, even if no tax benefit results from such inclusion in that year. See §1.1503(d)–5(c) *Examples 2* through *5*.

(14) *Foreign use*—(i) *In general.* A *foreign use* of a dual consolidated loss shall be deemed to occur when any portion of a loss or deduction taken into account in computing the dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is considered under U.S. tax principles to be an item of—

(A) A foreign corporation as defined in section 7701(a)(3) and (a)(5); or

(B) A direct or indirect owner of an interest in a hybrid entity, provided

such interest is not a separate unit. See §1.1503(d)-5(c) *Examples 6 through 11*.

(ii) *Available for use.* A foreign use shall be deemed to occur in the year in which any portion of a loss or deduction taken into account in computing the dual consolidated loss is made available for an offset described in paragraph (b)(14)(i) of this section, regardless of whether it actually offsets or reduces any items of income or gain under the income tax laws of the foreign country in such year and regardless of whether any of the items that may be so offset or reduced are regarded as income under U.S. tax principles.

(iii) *Exceptions—(A) No election to enable foreign use.* Where the laws of a foreign country provide an election that would enable a foreign use, a foreign use shall be considered to occur only if the election is made.

(B) *Presumed use where no foreign country rule for determining use.* If the losses or deductions composing the dual consolidated loss are made available under the laws of a foreign country both to offset income that would constitute a foreign use and to offset income that would not constitute a foreign use, and the laws of the foreign country do not provide applicable rules for determining which income is offset by the losses or deductions, then for purposes of paragraph (b)(14) of this section, the losses or deductions shall be deemed to be made available to offset income that does not constitute a foreign use, to the extent of such income, before being considered to be made available to offset the income that does constitute a foreign use. See §1.1503(d)-5(c) *Examples 12 and 14*.

(C) *No dilution of an interest in a separate unit—(1) General rules—(i) Interest in a hybrid entity partnership or hybrid entity grantor trust.* Except as provided in paragraph (b)(14)(iii)(C)(2) of this section, no foreign use shall be considered to occur with respect to a dual consolidated loss attributable to an interest in a hybrid entity partnership or a hybrid entity grantor trust, solely because an item of deduction or loss taken into account in computing such dual consolidated loss is made available, under the income tax laws of a foreign country, to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and, that is considered under U.S. tax principles, to be an item of

the direct or indirect owner of an interest in such hybrid entity that is not a separate unit. See §1.1503(d)-5(c) *Examples 8 and 14 through 16*.

(ii) *Indirectly owned separate units.* Except as provided in paragraph (b)(14)(iii)(C)(2) of this section, no foreign use shall be considered to occur with respect to a dual consolidated loss attributable to or taken into account by a separate unit owned indirectly through a partnership or grantor trust solely because an item of deduction or loss taken into account in computing such dual consolidated loss is made available, under the income tax laws of a foreign country, to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws, and that is considered under U.S. tax principles, to be an item of a direct or indirect owner of an interest in such partnership or trust. See §1.1503(d)-5(c) *Examples 17 and 18*.

(iii) *Combined separate unit.* This paragraph (b)(14)(iii)(C)(1)(iii) applies to a dual consolidated loss attributable to or taken into account by a combined separate unit that includes an individual separate unit to which paragraph (b)(14)(iii)(C)(1)(i) or (ii) of this section would apply, but for the application of the separate unit combination rule provided under §1.1503(d)-1(b)(4)(ii). Except as provided in paragraph (b)(14)(iii)(C)(2) of this section, paragraph (b)(14)(iii)(C)(1)(i) or (ii), as applicable, shall apply to the portion of the dual consolidated loss of such combined separate unit that is attributable, as provided under §1.1503(d)-3(b)(2)(vii)(B)(1), to the individual separate unit (otherwise described in paragraph (b)(14)(iii)(C)(1)(i) or (ii) of this section) that is a component of the combined separate unit. See §1.1503(d)-5(c) *Example 19*.

(2) *Exceptions—(i) Dilution of an interest in a separate unit.* Paragraph (b)(14)(iii)(C)(1) of this section shall not apply with respect to any item of deduction or loss that is taken into account in computing a dual consolidated loss attributable to or taken into account by a separate unit if during any taxable year the domestic owner's percentage interest in such separate unit, as compared to its interest in the separate unit as of the last day of the taxable year in which such dual consolidated loss was incurred, is reduced

as a result of another person acquiring through sale, exchange, contribution or other means, an interest in the partnership or grantor trust. The previous sentence shall not apply, however, if the unaffiliated domestic owner or consolidated group, as the case may be, demonstrates, to the satisfaction of the Commissioner, that the other person that acquired the interest in the partnership or grantor trust was a domestic corporation. Such demonstration must be made on a statement that is attached to, and filed by the due date (including extensions) of, its U.S. income tax return for the taxable year in which the ownership interest of the domestic owner is reduced. See §1.1503(d)-5(c) *Examples 14 through 16 and 19*.

(ii) *Consolidation and other prohibited uses.* Paragraph (b)(14)(iii)(C)(1) of this section shall not apply if the availability described in such section does not arise solely from the ownership in such partnership or grantor trust and the allocation of the item of deduction or loss, or the offsetting by such deduction or loss, of an item of income or gain of the partnership or trust. For example, paragraph (b)(14)(iii)(C)(1) of this section shall not apply in the case where the item of loss or deduction is made available through a foreign consolidation regime. See §1.1503(d)-5(c) *Examples 17 and 18*.

(iv) *Ordering rules for determining the foreign use of losses.* If the laws of a foreign country provide for the foreign use of a dual consolidated loss, but do not provide applicable rules for determining the order in which such losses are used in a taxable year, the following rules shall govern—

(A) Any net loss, or net income, that the dual resident corporation or separate unit has in a taxable year shall first be used to offset net income, or loss, recognized by its affiliates in the same taxable year before any carryover of its losses is considered to be used to offset any income from the taxable year;

(B) If under the laws of the foreign country the dual resident corporation or separate unit has losses from different taxable years, it shall be deemed to use first the losses from the earliest taxable year from which a loss may be carried forward or back for foreign law purposes; and

(C) Where different losses or deductions (for example, capital losses and ordinary losses) of a dual resident corporation

or separate unit incurred in the same taxable year are available for foreign use, the different losses shall be deemed to be used on a *pro rata* basis. See §1.1503(d)-5(c) *Example 13*.

(v) *Mirror legislation rule*. Except to the extent §1.1503(d)-4(b) applies, and other than for purposes of the consistency rule under §1.1503(d)-4(d)(2), a foreign use shall be deemed to occur if and when the income tax laws of a foreign country deny any opportunity for the foreign use of the dual consolidated loss for any of the following reasons—

(A) The loss is incurred by a dual resident corporation or separate unit that is subject to income taxation by another country on its worldwide income or on a residence basis;

(B) The loss may be available to offset income (other than income of the dual resident corporation or separate unit) under the laws of another country; or

(C) The deductibility of any portion of a loss or deduction taken into account in computing the dual consolidated loss depends on whether such amount is deductible under the laws of another country. See §1.1503(d)-5(c) *Examples 20* through *23*.

(15) *Grantor trust*. The term *grantor trust* means a trust, any portion of which is treated as being owned by the grantor or another person under subpart E of subchapter J of this chapter.

(c) *Special rules for filings under section 1503(d)*—(1) *Reasonable cause exception*. If a person that is permitted or required to file an election, agreement, statement, rebuttal, computation, or other information under the provisions of this section or §§1.1503(d)-2 through 1.1503(d)-4 and that fails to make such filing in a timely manner, shall be considered to have satisfied the timeliness requirement with respect to such filing if the person is able to demonstrate, to the Director of Field operations having jurisdiction of the taxpayer's tax return for the taxable year, that such failure was due to reasonable cause and not willful neglect. The previous sentence shall only apply if, once the person becomes aware of the failure, the person attaches all documents that should have been filed previously, as well as a written statement setting forth the reasons for the failure to timely comply, to an amended income tax return that

amends the return to which the documents should have been attached under the rules of this section or §§1.1503(d)-2 through 1.1503(d)-4. In determining whether the taxpayer has reasonable cause, the Director of Field Operations shall consider whether the taxpayer acted reasonably and in good faith. Whether the taxpayer acted reasonably and in good faith will be determined after considering all the facts and circumstances. The Director of Field Operations shall notify the person in writing within 120 days of the filing if it is determined that the failure to comply was not due to reasonable cause, or if additional time will be needed to make such determination.

(2) *Signature requirement*. When an election, agreement, statement, rebuttal, computation, or other information is required under this section or §§1.1503(d)-2 through 1.1503(d)-4 to be attached to and filed by the due date (including extensions) of a U.S. tax return and signed under penalties of perjury by the person who signs the return, the attachment and filing of an unsigned copy is considered to satisfy such requirement, provided the taxpayer retains the original in its records in the manner specified by §1.6001-1(e).

§1.1503(d)-2 Operating rules.

(a) *In general*. This section provides operating rules relating to dual consolidated losses, including a general rule prohibiting the domestic use of a dual consolidated loss, a rule that eliminates a dual consolidated loss following certain transactions, an anti-abuse rule for tainted income, and rules for computing foreign tax credit limitations.

(b) *Limitation on domestic use of a dual consolidated loss*. Except as provided in §1.1503(d)-4, the domestic use of a dual consolidated loss is not permitted. See §1.1503(d)-5(c) *Examples 2* through *4* and *5*.

(c) *Elimination of a dual consolidated loss after certain transactions*—(1) *General rules*—(i) *Dual resident corporation*. Except as provided in paragraph (c)(2) of this section, a dual consolidated loss of a dual resident corporation shall not carry over to another corporation in a transaction described in section 381(a) and, as a result, shall be eliminated. See §1.1503(d)-5(c) *Example 24*.

(ii) *Separate unit*—(A) *General rule*. Except as provided in paragraph (c)(2) of this section, a dual consolidated loss of a separate unit shall not carry over as a result of a transaction in which the separate unit ceases to be a separate unit of its domestic owner (for example, as a result of a termination, dissolution, liquidation, sale or other disposition of the separate unit) and, as a result, shall be eliminated.

(B) *Combined separate unit*. This paragraph (c)(1)(ii)(B) applies to an individual separate unit that is a component of a combined separate unit that would, but for the separate unit combination rule, cease to be a separate unit of its domestic owner. In such a case, and except as provided in paragraph (c)(2) of this section, the portion of the dual consolidated loss of the combined separate unit that is attributable to, or taken into account by, as provided under §1.1503(d)-3(b)(2)(vii)(B)(I), such individual separate unit shall not carry over and, as a result, shall be eliminated.

(2) *Exceptions*—(i) *Certain section 368(a)(1)(F) reorganizations*. Paragraph (c)(1)(i) of this section shall not apply to a reorganization described in section 368(a)(1)(F) in which the resulting corporation is a domestic corporation.

(ii) *Acquisition of a dual resident corporation by another dual resident corporation*. If a dual resident corporation transfers its assets to another dual resident corporation in a transaction described in section 381(a), and the transferee corporation is a resident of (or is taxed on its worldwide income by) the same foreign country of which the transferor was a resident (or was taxed on its worldwide income), then income generated by the transferee may be offset by the carryover dual consolidated losses of the transferor, subject to the limitations of §1.1503(d)-3(c) applied as if the transferee generated the dual consolidated loss. Dual consolidated losses of the transferor may not, however, be used to offset income of separate units owned by the transferee because such separate units constitute domestic affiliates of the transferee as provided under §1.1503(d)-1(b)(12)(iii).

(iii) *Acquisition of a separate unit by a domestic corporation*. If a domestic owner transfers ownership of a separate unit to a domestic corporation in a transaction described in section 381(a), and the transferee is a domestic owner of the sepa-

rate unit immediately following the transfer, then income generated by the separate unit following the transfer may be offset by the carryover dual consolidated losses of the separate unit, subject to the limitations of §1.1503(d)-3(c) applied as if the separate unit of the transferee generated the dual consolidated loss. In addition, if a domestic owner transfers ownership of a separate unit to a domestic corporation in a transaction described in section 381(a), the transferee is a domestic owner of the separate unit immediately following the transfer, and the transferred separate unit is combined with another separate unit of the transferee immediately after the transfer as provided under §1.1503(d)-1(b)(4)(ii), then income generated by the combined separate unit may be offset by the carryover dual consolidated losses of the transferred separate unit, subject to the limitations of §1.1503(d)-3(c) applied as if the combined separate unit of the transferee generated the dual consolidated loss. See §1.1503(d)-5(c) *Example 25*.

(d) *Special rule denying the use of a dual consolidated loss to offset tainted income*—(1) *In general*. Dual consolidated losses incurred by a dual resident corporation shall not be used to offset income it earns after it ceases to be a dual resident corporation to the extent that such income is tainted income.

(2) *Tainted income*—(i) *Definition*. For purposes of paragraph (d)(1) of this section, the term *tainted income* means—

(A) Income or gain recognized on the sale or other disposition of tainted assets; and

(B) Income derived as a result of holding tainted assets.

(ii) *Income presumed to be derived from holding tainted assets*. In the absence of evidence establishing the actual amount of income that is attributable to holding tainted assets, the portion of a corporation's income in a particular taxable year that is treated as tainted income derived as a result of holding tainted assets shall be an amount equal to the corporation's taxable income for the year (other than income described in paragraph (d)(2)(i)(A) of this section) multiplied by a fraction, the numerator of which is the fair market value of all tainted assets acquired by the corporation (determined at the time such assets were so acquired) and the denominator of which is the fair market value of

the total assets owned by the corporation at the end of such taxable year. To establish the actual amount of income that is attributable to holding tainted assets, documentation must be attached to, and filed by the due date (including extensions) of, the domestic corporation's tax return or the consolidated tax return of an affiliated group of which it is a member, as the case may be, for the taxable year in which the income is generated. See §1.1503(d)-5(c) *Example 26*.

(3) *Tainted assets defined*. For purposes of paragraph (d)(2) of this section, tainted assets are any assets acquired by a domestic corporation in a nonrecognition transaction, as defined in 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 dual resident corporation or at any time thereafter.

(4) *Exceptions*. Income derived from assets acquired by a domestic corporation shall not be subject to the limitation described in paragraph (d)(1) of this section, if—

(i) For the taxable year in which the assets were acquired, the corporation did not have a dual consolidated loss (or a carryforward of a dual consolidated loss to such year); or

(ii) The assets were acquired as replacement property in the ordinary course of business.

(e) *Computation of foreign tax credit limitation*. If a dual resident corporation or separate unit is subject to §1.1503(d)-3(c) (addressing the effect of a dual consolidated loss on a domestic affiliate), the consolidated group or unaffiliated domestic owner shall compute its foreign tax credit limitation by applying the limitations of §1.1503(d)-3(c). Thus, the items constituting the dual consolidated loss are not taken into account until the year in which such items are absorbed.

§1.1503(d)-3 Special rules for accounting for dual consolidated losses.

(a) *In general*. This section provides special rules for determining the amount of income or loss of a dual resident corporation or separate unit for purposes of section 1503(d). In addition, this section pro-

vides rules for determining the effect of a dual consolidated loss on domestic affiliates and for making special basis adjustments.

(b) *Determination of amount of dual consolidated loss*—(1) *Affiliated dual resident corporation*. For purposes of determining whether an affiliated dual resident corporation has a dual consolidated loss for the taxable year, the dual resident corporation shall compute its taxable income (or loss) in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income, taking into account only the dual resident corporation's items of income, gain, deduction, and loss for the year. However, for purposes of this computation, the following items shall not be taken into account—

(i) Any net capital loss of the dual resident corporation; and

(ii) Any carryover or carryback losses.

(2) *Separate unit*—(i) *General rules*. Paragraph (b)(2) of this section applies for purposes of determining whether a separate unit has a dual consolidated loss for the taxable year. The taxable income (or loss) in U.S. dollars of a separate unit shall be computed as if it were a separate domestic corporation and a dual resident corporation in accordance with the provisions of paragraph (b)(1) of this section, using only those existing items of income, gain, deduction, and loss (translated into U.S. dollars) that are attributable to or taken into account by such separate unit. Treating a separate unit as a separate domestic corporation of the domestic owner under this paragraph shall not cause items of income, gain, deduction and loss that are otherwise disregarded for U.S. Federal tax purposes to be regarded for purposes of calculating a dual consolidated loss. Paragraph (b)(2) of this section shall apply separately to each separate unit and an item of income, gain, deduction, or loss shall not be considered attributable to or taken into account by more than one separate unit. Items of income, gain, deduction, and loss of one separate unit shall not offset items of income, gain, deduction, and loss, or otherwise be taken into account by, another separate unit for purposes of calculating a dual consolidated loss. But see the separate unit combination rule in §1.1503(d)-1(b)(4)(ii). See also §1.1503(d)-5(c) *Example 27*.

(ii) *Foreign branch separate unit*—(A) *In general.* For purposes of determining the items of income, gain, deduction (other than interest), and loss that are taken into account in determining the taxable income or loss of a foreign branch separate unit, the principles of section 864(c)(2) and (c)(4) as set forth in §1.864-4(c) and §1.864-6 shall apply. The principles apply without regard to limitations imposed on the effectively connected treatment of income, gain or loss under the trade or business safe harbors in section 864(b) and the limitations for treating foreign source income as effectively connected under section 864(c)(4)(D). For purposes of determining the interest expense that is taken into account in determining the taxable income or loss of a foreign branch separate unit, the principles of §1.882-5, subject to paragraph (b)(2)(ii)(B) of this section, shall apply. When applying the principles of section 864(c) and §1.882-5 (subject to paragraph (b)(2)(ii)(B) of this section), the domestic corporation that owns, directly or indirectly, the foreign branch separate unit shall be treated as a foreign corporation, the foreign branch separate unit shall be treated as a trade or business within the United States, and the other assets of the domestic corporation shall be treated as assets that are not U.S. assets.

(B) *Principles of §1.882-5.* For purposes of paragraph (b)(2)(ii)(A) of this section, the principles of §1.882-5 shall be applied subject to the following—

(1) Except as otherwise provided in this section, only the assets, liabilities and interest expense of the domestic owner shall be taken into account in the §1.882-5 formula;

(2) Except as provided under paragraph (b)(2)(ii)(B)(3) of this section, a taxpayer may use the alternative tax book value method under §1.861-9T(i) for purposes of determining the value of its U.S. assets pursuant to §1.882-5(b)(2) and its worldwide assets pursuant to §1.882-5(c)(2);

(3) For purposes of determining the value of a U.S. asset pursuant to §1.882-5(b)(2), and worldwide assets pursuant to §1.882-5(c)(2), the taxpayer must use the same methodology under §1.861-9T(g) (that is, tax book value, alternative tax book value, or fair market value) that the taxpayer uses for purposes of allocating and apportioning interest ex-

pense for the taxable year under section 864(e);

(4) Asset values shall be determined pursuant to §1.861-9T(g)(2); and

(5) For purposes of determining the step-two U.S. connected liabilities, the amounts of worldwide assets and liabilities under §1.882-5(c)(2)(iii) and (iv), must be determined in accordance with U.S. tax principles rather than substantially in accordance with U.S. tax principles.

(iii) *Hybrid entity*—(A) *General rule.* The items of income, gain, deduction and loss attributable to a hybrid entity are those items that are properly reflected on its books and records under the principles of §1.988-4(b)(2), to the extent consistent with U.S. tax principles. See §1.1503(d)-5(c) *Example 28.*

(B) *Interest in a non-hybrid partnership and a non-hybrid grantor trust.* If a hybrid entity owns, directly or indirectly (other than through a hybrid entity separate unit), an interest in either a partnership that is not a hybrid entity or a grantor trust that is not a hybrid entity, items of income, gain, deduction or loss that are properly reflected on the books and records of such partnership or grantor trust (under the principles of §1.988-4(b)(2), to the extent consistent with U.S. tax principles), to the extent provided under paragraphs (b)(2)(v) or (b)(2)(vi) of this section, respectively, shall be treated as being properly reflected on the books and records of the hybrid entity for purposes of paragraph (b)(2)(iii)(A) of this section. See §1.1503(d)-5(c) *Example 30.*

(iv) *Interest in a disregarded hybrid entity.* Except as provided in paragraph (b)(2)(vii) of this section, for purposes of determining the items of income, gain, deduction and loss that are attributable to an interest in a hybrid entity that is disregarded as an entity separate from its owner (for example, as a result of an election made pursuant to §301.7701-3(c) of this chapter), those items described in paragraph (b)(2)(iii) of this section shall be taken into account. See §1.1503(d)-5(c) *Example 30.*

(v) *Items attributable to an interest in a hybrid entity partnership and a separate unit owned indirectly through a partnership*—(A) This paragraph (b)(2)(v) applies for purposes of determining—

(1) The extent to which the items of income, gain, deduction and loss attribut-

able to a hybrid entity that is a partnership (as provided in paragraph (b)(2)(iii) of this section) are attributable to an interest in such hybrid entity partnership; and

(2) The extent to which items of income, gain, deduction and loss of a separate unit that is owned indirectly through a partnership are taken into account by a partner in such partnership.

(B) Items of income, gain, deduction and loss are taken into account by the owner of such interest, or separate unit, to the extent such items are includible in the owner's distributive share of the partnership income, gain, deduction and loss, as determined under the rules and principles of subchapter K of this chapter. See §1.1503(d)-5(c) *Example 30.*

(vi) *Items attributable to an interest in a hybrid entity grantor trust and a separate unit owned indirectly through a grantor trust*—(A) This paragraph (b)(2)(vi) applies for purposes of determining—

(1) The extent to which items of income, gain, deduction and loss attributable to a hybrid entity that is a grantor trust (as provided in paragraph (b)(2)(iii) of this section) are attributable to an interest in such grantor trust; and

(2) The extent to which the items of income, gain, deduction and loss of a separate unit owned indirectly through a grantor trust are taken into account by an owner of such grantor trust.

(B) Items of income, gain, deduction and loss are taken into account to the extent such items are attributable to trust property that the holder of the trust interest is treated as owning under the rules and principles of subpart E of subchapter J of this chapter.

(vii) *Special rules.* The following special rules shall apply for purposes of attributing items under paragraphs (b)(2)(i) through (vi) of this section:

(A) *Allocation of items between certain tiered separate units*—(1) When a hybrid entity owns, directly or indirectly (other than through a hybrid entity separate unit), a foreign branch separate unit, for purposes of determining items of income, gain, deduction and loss that are taken into account in determining the taxable income or loss of such foreign branch separate unit, only items of income, gain, deduction and loss that are attributable to the hybrid entity as provided in paragraph (b)(2)(iii) of this section (and intervening entities, if any, that are not themselves separate units)

shall be taken into account. Items of the hybrid entity (including assets and liabilities) are taken into account for purposes of determining the taxable income or loss of the foreign branch separate unit pursuant to paragraph (b)(2)(ii) of this section. See §1.1503(d)-5(c) *Example 30*.

(2) For purposes of determining items of income, gain, deduction and loss that are attributable to an interest in the hybrid entity described in paragraph (b)(2)(vii)(A)(I) of this section, the items attributable to the hybrid entity in paragraph (b)(2)(iii) of this section shall not be taken into account to the extent they are also taken into account in determining, under the rules of paragraph (b)(2)(ii) of this section, the taxable income or loss of a foreign branch separate unit that is owned, directly or indirectly (other than through a hybrid entity separate unit), by the hybrid entity separate unit. See §1.1503(d)-5(c) *Example 30*.

(B) *Combined separate unit.* If two or more separate units defined in §1.1503(d)-1(b)(4)(i) are treated as one combined separate unit pursuant to §1.1503(d)-1(b)(4)(ii), the items of income, gain, deduction and loss that are attributable to or taken into account in determining the taxable income of the combined separate unit shall be determined as follows—

(1) Items of income, gain, deduction and loss are first attributed to, or taken into account by, each individual separate unit, as defined in §1.1503(d)-1(b)(4)(i) without regard to §1.1503(d)-1(b)(4)(ii), pursuant to the rules of paragraph (b)(2) of this section; and

(2) The combined separate unit then takes into account all of the items of income, gain, deduction and loss attributable to, or taken into account by, the individual separate units pursuant to paragraph (b)(2)(vii)(B)(I) of this section. See §1.1503(d)-5(c) *Example 30*.

(C) *Gain or loss on the direct or indirect disposition of a separate unit.* For purposes of calculating a dual consolidated loss of a separate unit, items of income or gain (including loss recapture income or gain under section 367(a)(3)(C) or 904(f)(3)), deduction and loss recognized on the sale, exchange or other disposition of a separate unit (or an interest in a partnership or grantor trust that owns, directly or indirectly, a separate unit), are

attributable to or taken into account by the separate unit to the extent of the gain or loss that would have been recognized had such separate unit sold all its assets in a taxable exchange, immediately before the disposition of the separate unit, for an amount equal to their fair market value. If, as a result of the sale, exchange or other disposition of a separate unit (or interest in a partnership or grantor trust) more than one separate unit is, directly or indirectly, disposed of, items of income, gain, deduction, and loss recognized on such disposition are attributable to or taken into account by each such separate unit (under the rules of this paragraph (b)(2)(vii)(C)) based on the gain or loss that would have been recognized by each separate unit if it had sold all of its assets in a taxable exchange, immediately before the disposition of the separate unit, for an amount equal to their fair market value. See §1.1503(d)-5(c) *Examples 31 through 34*.

(D) *Income inclusion on stock.* Any amount included in income of a U.S. person arising from ownership of stock in a foreign corporation (for example, under section 951) through a separate unit shall be taken into account for purposes of calculating the dual consolidated loss of the separate unit if an actual dividend from such foreign corporation would have been so taken into account. See §1.1503(d)-5(c) *Example 29*.

(3) *Foreign tax treatment disregarded.* The fact that a particular item taken into account in computing a dual resident corporation's net operating loss, or a separate unit's loss, is not taken into account in computing income subject to a foreign country's income tax shall not cause such item to be excluded from the calculation of the dual consolidated loss.

(4) *Items generated or incurred while a dual resident corporation or a separate unit.* For purposes of determining the amount of the dual consolidated loss of a dual resident corporation or a separate unit for the taxable year, only the items of income, gain, deduction and loss generated or incurred during the period the dual resident corporation or separate unit qualified as such shall be taken into account. The allocation of items to such period shall be made under the principles of §1.1502-76(b).

(c) *Effect of a dual consolidated loss on a domestic affiliate.* For any taxable year in which a dual resident corporation or separate unit has a dual consolidated loss to which §1.1503(d)-2(b) applies, the following rules shall apply:

(1) *Dual resident corporation.* If the dual resident corporation is a member of a consolidated group, the group shall compute its consolidated taxable income (or loss) by taking into account the dual resident corporation's items of gross income, gain, deduction, or loss taken into account in computing the dual consolidated loss, other than those items of deduction and loss that compose the dual resident corporation's dual consolidated loss. The dual consolidated loss shall be treated as composed of a *pro rata* portion of each item of deduction and loss of the dual resident corporation taken into account in calculating the dual consolidated loss. The dual consolidated loss is subject to the limitations on its use contained in paragraph (c)(3) of this section and, subject to such limitation, may be carried over or back for use in other taxable years as a separate net operating loss carryover or carryback of the dual resident corporation arising in the year incurred.

(2) *Separate unit.* The unaffiliated domestic owner of a separate unit, or the consolidated group of an affiliated domestic owner of a separate unit, shall compute its taxable income (or loss) by taking into account the separate unit's items of gross income, gain, deduction and loss taken into account in computing the dual consolidated loss, other than those items of deduction and loss that compose the separate unit's dual consolidated loss. The dual consolidated loss shall be treated as composed of a *pro rata* portion of each item of deduction and loss of the separate unit taken into account in calculating the dual consolidated loss. The dual consolidated loss is subject to the limitations contained in paragraph (c)(3) of this section as if the separate unit that generated the dual consolidated loss were a separate domestic corporation that filed a consolidated return with its unaffiliated domestic owner or with the consolidated group of its affiliated domestic owner. Subject to such limitation, the dual consolidated loss may be carried over or back for use in other taxable years as a separate net operating loss

carryover or carryback of the separate unit arising in the year incurred.

(3) *SRLY limitation.* The dual consolidated loss shall be treated as a loss incurred by the dual resident corporation or separate unit in a separate return limitation year and shall be subject to all of the limitations of §1.1502-21(c) (SRLY limitation), subject to the following—

(i) Notwithstanding §1.1502-1(f)(2)(i), the SRLY limitation is applied to any dual consolidated loss of a common parent;

(ii) The SRLY limitation is applied without regard to §1.1502-21(c)(2) (SRLY subgroup limitation) and 1.1502-21(g) (overlap with section 382);

(iii) For purposes of calculating the general SRLY limitation under §1.1502-21(c)(1)(i), the calculation of aggregate consolidated taxable income shall only include items of income, gain, deduction or loss generated—

(A) In the case of a dual resident corporation or hybrid entity separate unit, in years in which the dual resident corporation or hybrid entity (whose interest constitutes the separate unit) is resident (or is taxed on its worldwide income) in the same foreign country in which it was resident (or was taxed on its worldwide income) during the year in which the dual consolidated loss was generated; and

(B) In the case of a foreign branch separate unit, items of income, gain, deduction or loss generated in years in which the foreign branch qualified as a separate unit; and

(iv) For purposes of calculating the general SRLY limitation under §1.1502-21(c)(1)(i), the calculation of aggregate consolidated taxable income shall not include any amount included in income pursuant to §1.1503(d)-4(h) (relating to the recapture of a dual consolidated loss).

(4) *Items of a dual consolidated loss used in other taxable years.* A pro rata portion of each item of deduction or loss that composes the dual consolidated loss shall be considered to be used when the dual consolidated loss is used in other taxable years. See §1.1503(d)-5(c) *Example 35.*

(d) *Special basis adjustments—(1) Affiliated dual resident corporation or affiliated domestic owner.* If a dual resident corporation or domestic owner is a member of a consolidated group, each other

member owning stock in the dual resident corporation or domestic owner shall adjust the basis of the stock in accordance with the principles of §1.1502-32(b), subject to the following:

(i) *Dual consolidated loss subject to domestic use limitation.* There shall be a negative adjustment under §1.1502-32(b)(2) for any amount of a dual consolidated loss of the dual resident corporation (or, in the case of a domestic owner, of separate units of such domestic owner) that is not absorbed as a result of the application of §§1.1503(d)-2(b) and 3(c).

(ii) *Dual consolidated loss absorbed in carryover or carryback year.* There shall be no negative adjustment under §1.1502-32(b)(2) for the amount of a dual consolidated loss of the dual resident corporation (or, in the case of a domestic owner, of separate units of such domestic owner) subject to §§1.1503(d)-2(b) and 1.1503(d)-3(c) that is absorbed in a carryover or carryback taxable year.

(iii) *Recapture income.* There shall be no positive adjustment under §1.1502-32(b)(2) for any amount included in income by the dual resident corporation or domestic owner pursuant to §1.1503(d)-4(h).

(2) *Interests in hybrid entities that are partnerships or interests in partnerships through which a separate unit is owned indirectly—(i) Scope.* This paragraph (d)(2) applies for purposes of determining the adjusted basis of an interest in:

(A) A hybrid entity that is a partnership; and

(B) A partnership through which a domestic owner indirectly owns a separate unit.

(ii) *Determination of basis of partner's interest.* The adjusted basis of an interest in a hybrid entity that is a partnership, or a partnership through which a domestic owner indirectly owns a separate unit, shall be adjusted in accordance with section 705 of this chapter, except as otherwise provided in this paragraph (d)(2)(ii).

(A) *Dual consolidated loss subject to domestic use limitation.* The adjusted basis shall be decreased for any amount of the dual consolidated loss that is not absorbed as a result of the application of §§1.1503(d)-2(b) and 1.1503(d)-3(c).

(B) *Dual consolidated loss absorbed in carryover or carryback year.* The adjusted basis shall not be decreased for the

amount of a dual consolidated loss subject to §§1.1503(d)-2(b) and 1.1503(d)-3(c) that is absorbed in a carryover or carryback taxable year.

(C) *Recapture income.* The adjusted basis shall not be increased for any amount included in income pursuant to §1.1503(d)-4(h).

(3) *Examples.* See §1.1503(d)-5(c) *Examples 36 and 37.*

§1.1503(d)-4 *Exceptions to the domestic use limitation rule.*

(a) *In general.* This section provides certain exceptions to the domestic use limitation rule of §1.1503(d)-2(b).

(b) *Elective agreement in place between the United States and a foreign country.* The domestic use limitation rule of §1.1503(d)-2(b) shall not apply to a dual consolidated loss to the extent the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, elects to deduct the loss in the United States pursuant to an agreement entered into between the United States and a foreign country that puts into place an elective procedure through which losses offset income in only one country.

(c) *No possibility of foreign use—(1) In general.* The domestic use limitation rule of §1.1503(d)-2(b) shall not apply to a dual consolidated loss if the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be—

(i) Demonstrates, to the satisfaction of the Commissioner, that no foreign use of the dual consolidated loss occurred in the year in which it was incurred, and no such use can occur in any other year by any means; and

(ii) Prepares a statement described in paragraph (c)(2) of this section that is attached to, and filed by the due date (including extensions) of, its U.S. income tax return for the taxable year in which the dual consolidated loss is incurred. See §1.1503(d)-5(c) *Examples 38 through 40.*

(2) *Statement.* The statement described in this section must be signed under penalties of perjury by the person who signs the tax return. The statement must be labeled No Possibility of Foreign Use of Dual Consolidated Loss Statement at the top of the page and must include the following items, in paragraphs labeled to cor-

respond with the items set forth in paragraphs (c)(2)(i) through (iv) of this section:

(i) A statement that the document is submitted under the provisions of §1.1503(d)–4(c);

(ii) The name, address, tax identification number, and place and date of incorporation of the dual resident corporation, and the country or countries that tax the dual resident corporation on its worldwide income or on a residence basis, or, in the case of a separate unit, identification of the separate unit, including the name under which it conducts business, its principal activity, and the country in which its principal place of business is located;

(iii) A statement of the amount of the dual consolidated loss at issue; and

(iv) An analysis, in reasonable detail and specificity, supported with official or certified English translations of the relevant provisions of foreign law, of the treatment of the losses and deductions composing the dual consolidated loss under the laws of the foreign jurisdiction and the reasons supporting the conclusion that no foreign use of the dual consolidated loss occurred in the year in which it was incurred, and no such use can occur in any other year by any means.

(d) *Domestic use election*—(1) *In general*. The domestic use limitation rule of §1.1503(d)–2(b) shall not apply to a dual consolidated loss if an election to be bound by the provisions of this paragraph (d) of this section (domestic use election) is made by the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be (elector). In order to elect relief under this paragraph (d) of this section, an agreement described in this paragraph (d)(1) of this section (domestic use agreement) must be attached to, and filed by the due date (including extensions) of, the U.S. income tax return of the elector for the taxable year in which the dual consolidated loss is incurred. The domestic use agreement must be signed under penalties of perjury by the person who signs the return. If dual consolidated losses of more than one dual resident corporation or separate unit are subject to the rules of this paragraph (d) which requires the filing of domestic use agreements by the same elector, the agreements may be combined in a single document, but the information required by paragraphs (d)(1)(ii) and (iv) of this section must be

provided separately with respect to each dual consolidated loss. The domestic use agreement must be labeled Domestic Use Election and Agreement at the top of the page and must include the following items, in paragraphs labeled to correspond with the following:

(i) A statement that the document submitted is an election and an agreement under the provisions of §1.1503(d)–4(d);

(ii) The name, address, tax identification number, and place and date of incorporation of the dual resident corporation, and the country or countries that tax the dual resident corporation on its worldwide income or on a residence basis, or, in the case of a separate unit, identification of the separate unit, including the name under which it conducts business, its principal activity, and the country in which its principal place of business is located;

(iii) An agreement by the elector to comply with all of the provisions of paragraphs (d) through (h) of this section, as applicable;

(iv) A statement of the amount of the dual consolidated loss covered by the agreement;

(v) A certification that there has not been, and will not be, a foreign use of the dual consolidated loss in any taxable year up to and including the seventh taxable year following the year in which the dual consolidated loss that is the subject of the agreement filed under paragraph (d) of this section was incurred (certification period);

(vi) A certification that arrangements have been made to ensure that there will be no foreign use of the dual consolidated loss during the certification period, and that the elector will be informed of any such foreign use of the dual consolidated loss during such period;

(vii) If applicable, a notification that an excepted triggering event under paragraph (f)(2)(i) of this section has occurred with respect to the dual consolidated loss within the taxable year covered by the elector's tax return and providing the name, taxpayer identification number, and address of the subsequent elector (within the meaning of paragraph (f)(2)(iii)(A) of this section) that will be filing future certifications with respect to such dual consolidated loss.

(2) *Consistency rule*. If under the laws of a particular foreign country there is a foreign use of a dual consolidated loss of a dual resident corporation or separate unit

that is subject to a domestic use agreement (but not a new domestic use agreement, defined in paragraph (f)(2)(iii)(A) of this paragraph), then a foreign use shall be deemed to occur for the following other dual consolidated losses (if any), but only if the income tax laws of the foreign country permit a foreign use of such other dual consolidated losses in the same taxable year—

(i) Any dual consolidated loss of a dual resident corporation that is a member of the same consolidated group of which the first dual resident corporation or domestic owner is a member, if any deduction or loss taken into account in computing such dual consolidated loss is recognized under the income tax laws of such foreign country in the same taxable year; and

(ii) Any dual consolidated loss of a separate unit that is owned directly or indirectly by the same domestic owner that owns the first separate unit, or that is owned directly or indirectly by any member of the same consolidated group of which the first dual resident corporation or domestic owner is a member, if any deduction or loss taken into account in computing such dual consolidated loss is recognized under the income tax laws of such foreign country in the same taxable year. See §1.1503(d)–5(c) *Examples 41 and 42*.

(3) *Restrictions on domestic use election*—(i) *Triggering event in year of dual consolidated loss*. Except as otherwise provided in this section, if an event described in paragraphs (e)(1)(i) through (vii) of this section occurs during the year in which a dual resident corporation or separate unit incurs a dual consolidated loss (including a dual consolidated loss resulting, in whole or in part, from the occurrence of the triggering event itself), the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, may not make a domestic use election with respect to the dual consolidated loss and such loss therefore is subject to the domestic use limitation rule of §1.1503(d)–2(b). See §1.1503(d)–5(c) *Example 32*. See also §1.1503(d)–2(c) for rules that eliminate a dual consolidated loss after certain transactions.

(ii) *Losses of a foreign insurance company treated as a domestic corporation*. A foreign insurance company that has

ected to be treated as a domestic corporation pursuant to section 953(d) may not make a domestic use election. See section 953(d)(3).

(e) *Triggering events requiring the recapture of a dual consolidated loss*—(1) *Events*. The elector must agree that, except as provided under paragraphs (e)(2) and (f) of this section, if there is a triggering event described in this paragraph (e) during the certification period, the elector will recapture and report as income the amount of the dual consolidated loss as provided in paragraph (h) of this section on its tax return for the taxable year in which the triggering event occurs (or, when the triggering event is a foreign use of the dual consolidated loss, the taxable year that includes the last day of the foreign tax year during which such use occurs). In addition, the elector must pay any applicable interest charge required by paragraph (h) of this section. For purposes of this section, except as provided under paragraphs (e)(2) and (f) of this section, any of the following events shall constitute a triggering event:

(i) *Foreign use*. A foreign use of the dual consolidated loss (including a deemed foreign use pursuant to the mirror legislation rule set forth in §1.1503(d)-1(b)(13)(ii)(D) or the consistency rule set forth in paragraph (d)(2) of this section).

(ii) *Disaffiliation*. An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of the consolidated group that made the domestic use election. For purposes of this paragraph (e)(1)(ii), a dual resident corporation or domestic owner shall be considered to cease to be a member of the consolidated group if it is no longer a member of the group within the meaning of §1.1502-1(b), or if the group ceases to exist (for example, when the group no longer files a consolidated return). See §1.1503(d)-5(c) *Example 47*.

(iii) *Affiliation*. An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group. Any consequences resulting from this triggering event (for example, recapture of a dual consolidated loss) shall be taken into account in the tax return of the unaffiliated dual resident corporation or unaffiliated domestic owner for the taxable year that ends immediately before the taxable year in which the unaffiliated dual

resident corporation or unaffiliated domestic owner becomes a member of the consolidated group.

(iv) *Transfer of assets*. Fifty percent or more of the dual resident corporation's or separate unit's gross assets (measured by the fair market value of the assets at the time of such transfer (or for multiple transactions, at the time of the first transfer)) are sold or otherwise disposed of in either a single transaction or a series of transactions within a twelve-month period. For purposes of this paragraph, the interest in a separate unit and the shares of a dual resident corporation shall not be treated as assets of a dual resident corporation or a separate unit.

(v) *Transfer of an interest in a separate unit*. Fifty percent or more of the interest in a separate unit (measured by voting power or value) owned directly or indirectly by the domestic owner on the last day of the taxable year in which the dual consolidated loss was incurred is sold or otherwise disposed of either in a single transaction or a series of transactions within a twelve-month period.

(vi) *Conversion to a foreign corporation*. An unaffiliated dual resident corporation, unaffiliated domestic owner, or hybrid entity an interest in which is a separate unit, becomes a foreign corporation by means of a transaction (for example, a reorganization, or an election to be classified as a corporation under §301.7701-3(c) of this chapter) that, for foreign tax purposes, is not treated as involving a transfer of assets (and carryover of losses) to a new entity.

(vii) *Conversion to an S corporation*. An unaffiliated dual resident corporation or unaffiliated domestic owner elects to be an S corporation pursuant to section 1362(a).

(viii) *Failure to certify*. The elector fails to file a certification required under paragraph (g) of this section.

(2) *Rebuttal*. An event described in paragraphs (e)(1)(ii) through (viii) of this section shall not constitute a triggering event if the elector demonstrates, to the satisfaction of the Commissioner, that there can be no foreign use of the dual consolidated loss at any time during the remaining certification period. The elector must prepare a statement, labeled *Rebuttal of Triggering Event* at the top of the page, that indicates that it is submit-

ted under the provisions of this section §1.1503(d)-4(e)(2). The statement must set forth an analysis, in reasonable detail and specificity, supported with official or certified English translations of the relevant provisions of foreign law, of the treatment of the losses and deductions composing the dual consolidated loss under the facts of the event in question. The statement must be attached to, and filed by the due date (including extensions) of, the elector's income tax return for the taxable year in which the presumed triggering event occurs. See §1.1503(d)-5(c) *Examples 43 through 45*.

(f) *Exceptions*—(1) *Acquisition by a member of the consolidated group*. The following events shall not constitute triggering events, requiring the recapture of the dual consolidated loss under paragraph (h) of this section—

(i) An affiliated dual resident corporation or affiliated domestic owner ceases to be a member of a consolidated group solely by reason of a transaction in which a member of the same consolidated group succeeds to the tax attributes of the dual resident corporation or domestic owner under the provisions of section 381.

(ii) Assets of an affiliated dual resident corporation or assets of a separate unit owned by an affiliated domestic owner are acquired in any other transaction by—

(A) One or more members of its consolidated group; or

(B) A partnership, a grantor trust, or a hybrid entity, but only if 100 percent of such entity's interests are owned, directly or indirectly, by such affiliated dual resident corporation or affiliated domestic owner, as the case may be, or by members of its consolidated group.

(iii) Assets of a separate unit are acquired in any other transaction by its domestic owner or by a hybrid entity or grantor trust, but only if 100 percent of such entity's interest is owned by the domestic owner.

(iv) The interest of a hybrid entity separate unit, or an indirectly owned separate unit, owned by an affiliated domestic owner, is transferred to—

(A) A member of its consolidated group; or

(B) A partnership, a grantor trust, or a hybrid entity, but only if 100 percent of such entity's interests are owned, directly or indirectly, by such affiliated domestic

owner, or by members of its consolidated group.

(2) *Acquisition by an unaffiliated domestic corporation or a new consolidated group*—(i) *Subsequent elector events*. If all the requirements of paragraph (f)(2)(iii) of this section are met, the following events shall not constitute triggering events requiring the recapture of the dual consolidated loss under paragraph (h) of this section—

(A) An affiliated dual resident corporation or affiliated domestic owner becomes an unaffiliated domestic corporation or a member of a new consolidated group (other than in a transaction described in paragraph (f)(2)(ii)(B) of this section);

(B) Assets of a dual resident corporation or a separate unit are acquired by—

(1) An unaffiliated domestic corporation;

(2) One or more members of a new consolidated group; or

(3) A partnership, a grantor trust, or a hybrid entity, but only if 100 percent of such entity's interests are owned, directly or indirectly, by members of a new consolidated group.

(C) The interest of a hybrid entity separate unit, or an indirectly owned separate unit, owned by a domestic owner is transferred to—

(1) An unaffiliated domestic corporation;

(2) One or more members of a new consolidated group; or

(3) A partnership, a grantor trust, or a hybrid entity, but only if 100 percent of such entity's interests is owned, directly or indirectly, by members of a new consolidated group.

(ii) *Non-subsequent elector events*. If the requirements of paragraph (f)(2)(iii)(A) of this section are met, the following events also shall not constitute triggering events requiring the recapture of the dual consolidated loss under paragraph (h) of this section—

(A) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group; or

(B) A consolidated group that filed a domestic use agreement ceases to exist as a result of a transaction described in §1.1502-13(j)(5)(i) (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). See §1.1503(d)-5(c) *Example 46*.

(iii) *Requirements*—(A) *New domestic use agreement*. The unaffiliated domestic corporation or new consolidated group (subsequent elector) must file an agreement described in paragraph (d)(1) of this section (new domestic use agreement). The new domestic use agreement must be labeled New Domestic Use Agreement at the top of the page, and must be attached to and filed by the due date (including extensions) of, the subsequent elector's income tax return for the taxable year in which the event described in paragraph (f)(2)(i) or (f)(2)(ii) of this section occurs. The new domestic use agreement must be signed under penalties of perjury by the person who signs the return and must include the following items—

(1) A statement that the document submitted is an election and agreement under the provisions of §1.1503(d)-4(f)(2);

(2) An agreement to assume the same obligations with respect to the dual consolidated loss as the corporation or consolidated group that filed the original domestic use agreement (original elector) with respect to that loss;

(3) An agreement to treat any potential recapture amount under paragraph (h) of this section with respect to the dual consolidated loss as unrealized built-in gain for purposes of section 384(a), subject to any applicable exceptions thereunder;

(4) An agreement to be subject to the successor elector rules as provided in paragraph (h)(3) of this section; and

(5) The name, U.S. taxpayer identification number, and address of the original elector and prior subsequent electors with respect to the dual consolidated losses, if any.

(B) *Statement filed by original elector*. The original elector 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 described in paragraph (f)(2)(i) of this section occurs. The statement must be labeled Original Elector Statement at the top of the page, must be signed under penalties of perjury by the person who signs the tax return, and must include the following items—

(1) A statement that the document submitted is an election and agreement under the provisions of §1.1503(d)-4(f)(2);

(2) An agreement to be subject to the successor elector rules as provided in paragraph (h)(3) of this section; and

(3) The name, U.S. taxpayer identification number, and address of the subsequent elector.

(3) *Subsequent triggering events*. Any triggering event described in paragraph (e) of this section that occurs subsequent to one of the transactions described in paragraph (f)(1) or (2) of this section, and that itself does not fall within the exceptions provided in paragraph (f)(1) or (2) of this section, shall require recapture under paragraph (h) of this section.

(g) *Annual certification reporting requirement*. Except as provided in paragraph (i) of this section, the elector must file a certification, labeled Certification of Dual Consolidated Loss at the top of the page, that is attached to, and filed by the due date (including extensions) of, its income tax return for each taxable year during the certification period. The certification must certify that there has been no foreign use of such dual consolidated loss. The certification must identify the dual consolidated loss to which it pertains by setting forth the elector's year in which the loss was incurred and the amount of such loss. In addition, the certification must warrant that arrangements have been made to ensure that there will be no foreign use of the dual consolidated loss and that the elector will be informed of any such foreign use. If dual consolidated losses of more than one taxable year are subject to the rules of this paragraph (g) of this section, the certification for those years may be combined in a single document but each dual consolidated loss must be separately identified.

(h) *Recapture of dual consolidated loss and interest charge*—(1) *Presumptive rules*—(i) *Amount of recapture*. Except as otherwise provided in this section, upon the occurrence of a triggering event described in paragraph (e)(1) of this section that falls outside the exceptions provided in paragraph (f)(1) or (2) of this section, the dual resident corporation or separate unit shall recapture, and the elector shall report, as gross income the total amount of the dual consolidated loss to which the triggering event applies on its income tax

return for the taxable year in which the triggering event occurs (or, when the triggering event is a foreign use of the dual consolidated loss, the taxable year that includes the last day of the foreign tax year during which such foreign use occurs).

(ii) *Interest charge.* In connection with the recapture, the elector shall pay an interest charge. Except as otherwise provided in this section, such interest shall be determined under the rules of section 6601(a) as if the additional tax owed as a result of the recapture had accrued and been due and owing for the taxable year in which the losses or deductions taken into account in computing the dual consolidated loss gave rise to a tax benefit for U.S. income tax purposes. For purposes of this paragraph (h)(1)(ii), a tax benefit shall be considered to have arisen in a taxable year in which such losses or deductions reduced U.S. taxable income. See §1.1503(d)–5(c) *Example 51.*

(2) *Reduction of presumptive recapture amount and presumptive interest charge*

—(i) *Amount of recapture.* The amount of dual consolidated loss that must be recaptured under paragraph (h) of this section may be reduced if the elector demonstrates, to the satisfaction of the Commissioner, the offset permitted by this paragraph (h)(2)(i). The reduction in the amount of recapture is the amount by which the dual consolidated loss would have offset other taxable income reported on a timely filed U.S. income tax return for any taxable year up to and including the taxable year of the triggering event if such loss had been subject to the restrictions of §1.1503(d)–2(b) (and therefore subject to the limitation under §1.1503(d)–3(c)(3)). In the case of a separate unit, the prior sentence is applied as if the separate unit were a separate domestic corporation that filed a consolidated return with its unaffiliated domestic owner or with the consolidated group of its affiliated domestic owner. For purposes of determining the reduction in the amount of recapture pursuant to this paragraph, the rules under §1.1503(d)–3(b) shall apply. Any reduction to recapture pursuant to this paragraph that is attributable to income generated in taxable years prior to the year in which the dual consolidated loss was generated, subject to the restrictions of §1.1503(d)–2(b) (and therefore subject to the limitation under §1.1503(d)–3(c)(3)), shall be per-

mitted only if the elector demonstrates to the satisfaction of the Commissioner that the dual resident corporation or separate unit, as the case may be, qualified as such (with respect to the same foreign country in which the dual consolidated loss was generated) in the taxable years such income was generated. An elector utilizing this rebuttal rule must prepare a separate accounting showing that the income for each year that offsets the dual resident corporation or separate unit's recapture amount is attributable only to the dual resident corporation or separate unit. The separate accounting must be signed under penalties of perjury by the person who signs the elector's tax return, must be labeled Reduction of Recapture Amount at the top of the page, and must indicate that it is submitted under the provisions of paragraph (h)(2)(i) of this section. The accounting must be attached to, and filed by the due date (including extensions) of, the elector's income tax return for the taxable year in which the triggering event occurs.

(ii) *Interest charge.* The interest charge imposed under this section may be appropriately reduced if the elector demonstrates, to the satisfaction of the Commissioner, that the net interest owed would have been less than that provided in paragraph (h)(1)(ii) of this section if the elector had filed an amended return for the taxable year in which the loss was incurred, and for any other affected taxable years up to and including the taxable year of recapture, treating the dual consolidated loss as a loss subject to the restrictions of §1.1503(d)–2(b) (and therefore subject to the limitations under §1.1503(d)–3(c)(3)). In the case of a separate unit, the prior sentence is applied as if the separate unit were a separate domestic corporation that filed a consolidated return with its unaffiliated domestic owner. An elector utilizing this rebuttal rule must prepare a computation demonstrating the reduction in the net interest owed as a result of treating the dual consolidated loss as a loss subject to the restrictions of §1.1503(d)–2(b) (and therefore subject to the limitations under §1.1503(d)–3(c)(3)). The computation must be labeled Reduction of Interest Charge at the top of the page and must indicate that it is submitted under the provisions of paragraph (h)(2)(ii) of this section. The computation must be signed under penalties of perjury by the person who

signs the elector's tax return, and must be attached to, and filed by the due date (including extensions) of, the elector's income tax return for the taxable year in which the triggering event occurs. See §1.1503(d)–5(c) *Examples 51 and 52.*

(3) *Rules regarding subsequent electors*—(i) *In general.* The rules of this paragraph (h)(3) apply when, subsequent to an event described in paragraph (e)(1) of this section with respect to which the requirements of paragraph (f)(2)(i) of this section were met (excepted event), a triggering event under paragraph (e) of this section occurs, and no exception applies to such triggering event under paragraph (f) of this section (subsequent triggering event).

(ii) *Original elector and prior subsequent electors not subject to recapture or interest charge*—(A) Except to the extent provided in paragraph (h)(3) of this section, neither the original elector nor any prior subsequent elector shall be subject to the rules of paragraph (h) of this section with respect to dual consolidated losses subject to the original domestic use agreement.

(B) In the case of a dual consolidated loss with respect to which multiple excepted events have occurred, only the subsequent elector that owns the dual resident corporation or separate unit at the time of the subsequent triggering event shall be subject to the recapture rules of paragraph (h) of this section. For purposes of paragraph (h) of this section, the term *prior subsequent elector* refers to all other subsequent electors.

(iii) *Recapture tax amount and required statement*—(A) *In general.* If a subsequent triggering event occurs, the subsequent elector must prepare a statement that computes the recapture tax amount, as provided under paragraph (h)(3)(iii)(B) of this section, with respect to the dual consolidated loss subject to the new domestic use agreement. This statement must be attached to, and filed by the due date (including extensions) of, the subsequent elector's income tax return for the taxable year in which the subsequent triggering event occurs. The statement must be signed under penalties of perjury by the person who signs the return. The statement must be labeled Statement Identifying Secondary Liability at the top and, in addition to the calculation of the recapture tax amount, must include the

following items, in paragraphs labeled to correspond with the items set forth in paragraphs (h)(3)(iii)(A)(I) through (3) of this section:

(1) A statement that the document is submitted under the provisions of §1.1503(d)-4(h)(3)(iii);

(2) A statement identifying the amount of the dual consolidated losses at issue and the taxable year in which they were used;

(3) The name, address, and tax identification number of the original elector and all prior subsequent electors.

(B) *Recapture tax amount.* The *recapture tax amount* equals the excess (if any) of—

(1) The income tax liability of the subsequent elector for the taxable year of the subsequent triggering event; over

(2) The income tax liability of the subsequent elector for the taxable year of the subsequent triggering event, computed by excluding the amount of recapture and related interest charge with respect to the dual consolidated losses that are recaptured as a result of the subsequent triggering event, as provided under paragraphs (h)(1) and (h)(2) of this section.

(iv) *Tax assessment and collection procedures—(A) In general—(1) Subsequent elector.* An assessment identifying an income tax liability of the subsequent elector is considered an assessment of the recapture tax amount where the recapture tax amount is part of the income tax liability being assessed and the recapture tax amount is reflected in a statement attached to the subsequent elector's income tax return as provided under paragraph (h)(3)(iii) of this section.

(2) *Original elector and prior subsequent electors.* The assessment of the recapture tax amount as set forth in paragraph (h)(3)(iv)(A)(1) of this section shall be considered as having been properly assessed as an income tax liability of the original elector and of each prior subsequent elector, if any. The date of such assessment shall be the date the income tax liability of the subsequent elector was properly assessed. The Commissioner may collect all or a portion of such recapture tax amount from the original elector and/or the prior subsequent electors under the circumstances set forth in paragraph (h)(3)(iv)(B) of this section.

(B) *Collection from original elector and prior subsequent electors; joint and*

several liability. If the subsequent elector does not pay in full any of the income tax liability that includes a recapture tax amount, the Commissioner may collect that portion of the unpaid balance of such income tax liability attributable to the recapture tax amount in full or in part from the original elector and/or from any prior subsequent elector, provided that the following conditions are satisfied with respect to such elector—

(1) The Commissioner properly has assessed the recapture tax amount pursuant to paragraph (h)(3)(iv)(A)(I) of this section;

(2) The Commissioner has issued a notice and demand for payment of the recapture tax amount to the subsequent elector in accordance with §301.6303-1 of this chapter;

(3) The subsequent elector has failed to pay all of the recapture tax amount by the date specified in such notice and demand; and

(4) The Commissioner has issued a notice and demand for payment of the unpaid portion of the recapture tax amount to the original elector, or prior subsequent elector (as the case may be), in accordance with §301.6303-1 of this chapter. The liability imposed under this paragraph (h)(3)(iv)(B) on the original elector and each prior subsequent elector shall be joint and several.

(C) *Allocation of partial payments of tax.* If the subsequent elector's income tax liability for a taxable period includes a recapture tax amount, and if such income tax liability is satisfied in part by payment, credit, or offset, such payment, credit or offset shall be allocated first to that portion of the income tax liability that is not attributable to the recapture tax amount, and then to that portion of the income tax liability that is attributable to the recapture tax amount.

(D) *Refund.* If the Commissioner makes a refund of any income tax liability that includes a recapture tax amount, the Commissioner shall allocate and pay the refund to each elector who paid a portion of such income tax liability as follows:

(1) The Commissioner shall first determine the total amount of recapture tax paid by and/or collected from the original elector and from any prior subsequent elector(s). The Commissioner shall then allocate and pay such refund to the origi-

nal elector and prior subsequent elector(s), with each such elector receiving an amount of such refund on a *pro rata* basis, not to exceed the amount of recapture tax paid by and/or collected from such elector.

(2) The Commissioner shall pay any balance of such refund, if any, to the subsequent elector.

(v) *Definition of income tax liability.* Solely for purposes of paragraph (h)(3) of this section, the term *income tax liability* means the income tax liability imposed on a domestic corporation under Title 26 of the United States Code for a taxable year, including additions to tax, additional amounts, penalties, and any interest charge related to such income tax liability.

(vi) *Example.* See §1.1503(d)-5(c) *Example 49.*

(4) *Computation of taxable income in year of recapture—(i) Presumptive rule.* Except to the extent provided in paragraph (h)(4)(ii) of this section, for purposes of computing the taxable income for the year of recapture, no current, carryover or carryback losses of the dual resident corporation or separate unit, of other members of the consolidated group, or of the domestic owner that are not attributable to the separate unit, may offset and absorb the recapture amount.

(ii) *Rebuttal of presumptive rule.* The recapture amount included in gross income may be offset and absorbed by that portion of the elector's (consolidated or separate) net operating loss carryover that is attributable to the dual consolidated loss being recaptured, if the elector demonstrates, to the satisfaction of the Commissioner, the amount of such portion of the carryover. An elector utilizing this rebuttal rule must prepare a computation demonstrating the amount of net operating loss carryover that, under this paragraph (h)(4)(ii) of this section, may absorb the recapture amount included in gross income. Such computation must be signed under penalties of perjury and attached to and filed by the due date (including extensions) of, the income tax return for the taxable year in which the triggering event occurs.

(5) *Character and source of recapture income.* The amount recaptured under paragraph (h) of this section shall be treated as ordinary income. Except as provided in the prior sentence, such income shall be treated, as applicable, as income from the same source, having

the same character, and falling within the same separate category, for all purposes of the Internal Revenue Code, including sections 856(c)(2) and (3), 904(d), and 907, to which the items of deduction or loss composing the dual consolidated loss were allocated and apportioned, as provided under sections 861(b), 862(b), 863(a), 864(e), 865 and the regulations thereunder. See §1.1503(d)–5(c) *Example 50*.

(6) *Reconstituted net operating loss*. Commencing in the taxable year immediately following the year in which the dual consolidated loss is recaptured, the dual resident corporation or separate unit (but only if such separate unit is owned, directly or indirectly, by a domestic corporation) shall be treated as having a net operating loss in an amount equal to the amount actually recaptured under paragraph (h) of this section. This reconstituted net operating loss shall be subject to the restrictions of §1.1503(d)–2(b) (and therefore, the restrictions of §1.1503(d)–3(c)(3)), without regard to the exceptions contained in paragraphs (b) through (d) of this section. The net operating loss shall be available only for carryover, under section 172(b), to taxable years following the taxable year of recapture. For purposes of determining the remaining carryover period, the loss shall be treated as if it had been recognized in the taxable year in which the dual consolidated loss that is the basis of the recapture amount was incurred. See §1.1503(d)–5(c) *Example 52*.

(i) *Termination of domestic use agreement and annual certifications*—(1) *Rebuttal of triggering event*. If, pursuant to paragraph (e)(2) of this section, an elector is able to rebut the presumption of a triggering event described in paragraphs (e)(1)(ii) through (ix) of this section, including complying with the related reporting requirements, then the domestic use agreement filed with respect to any dual consolidated losses that would have been recaptured as a result of the event, but for the rebuttal, shall terminate and have no further effect. See §1.1503(d)–5(c) *Example 43*.

(2) *Exception to triggering event*. If an event described in paragraph (e)(1) of this section is not a triggering event as a result of the application of paragraph (f)(2)(i) or (ii) of this section, then the domestic use agreement filed with respect to

any dual consolidated losses that would have been recaptured as a result of the event, but for the application of paragraph (f)(2)(i) or (f)(2)(ii) of this section, shall terminate and have no further effect. See §1.1503(d)–5(c) *Examples 46 and 49*.

(3) *Recapture of dual consolidated loss*. If a dual consolidated loss is recaptured pursuant to paragraph (h) of this section, then the domestic use agreement filed with respect to such recaptured dual consolidated loss shall terminate and have no further effect. See §1.1503(d)–5(c) *Examples 49 through 52*.

(4) *Termination of ability for foreign use*—(i) *In general*. A domestic use agreement filed with respect to a dual consolidated loss shall terminate and have no further effect as of the end of a taxable year if the elector—

(A) Demonstrates, to the satisfaction of the Commissioner, that as of the end of such taxable year no foreign use of the dual consolidated loss can occur in any year by any means; and

(B) Prepares a statement described in paragraph (i)(4)(ii) of this section that is attached to, and filed by the due date (including extensions) of, its U.S. income tax return for such taxable year.

(ii) *Statement*. The statement described in this paragraph (i)(4)(ii) must be signed under penalties of perjury by the person who signs the return. The statement must be labeled Termination of Ability for Foreign Use at the top of the page and must include the following items, in paragraphs labeled to correspond with the following:

(A) A statement that the document is submitted under the provisions of §1.1503(d)–4(i)(4).

(B) The name, address, tax identification number, and place and date of incorporation of the dual resident corporation, and the country or countries that tax the dual resident corporation on its worldwide income or on a residence basis, or, in the case of a separate unit, identification of the separate unit, including the name under which it conducts business, its principal activity, and the country in which its principal place of business is located.

(C) A statement of the amount of the dual consolidated loss at issue and the year in which such dual consolidated loss was incurred.

(D) An analysis, in reasonable detail and specificity, supported with official or

certified English translations of the relevant provisions of foreign law, of the treatment of the losses and deductions composing the dual consolidated loss under the laws of the foreign jurisdiction and the reasons supporting the conclusion that no foreign use of the dual consolidated loss can occur in any year by any means.

§1.1503(d)–5 Examples.

(a) *In general*. This section provides examples that illustrate the application of §§1.1503(d)–1 through 1.1503(d)–4. This section also provides facts that are presumed for such examples.

(b) *Presumed facts for examples*. For purposes of the examples in this section, unless otherwise indicated, the following facts are presumed:

(1) Each entity has only a single class of equity outstanding, all of which is held by a single owner.

(2) P, a domestic corporation and the common parent of the P consolidated group, owns S, a domestic corporation and a member of the P consolidated group.

(3) DRC_X, a domestic corporation, is subject to Country X tax on its worldwide income or on a residence basis, and is a dual resident corporation.

(4) DE1_X and DE2_X are both Country X entities, subject to Country X tax on their worldwide income or on a residence basis, and disregarded as entities separate from their owners for U.S. tax purposes. DE3_Y is a Country Y entity, subject to Country Y tax on its worldwide income or on a residence basis, and disregarded as an entity separate from its owner for U.S. tax purposes. The interests in DE1_X, DE2_X, and DE3_Y constitute hybrid entity separate units.

(5) FB_X is a foreign branch, as defined in §1.367(a)–6T(g), and is a Country X foreign branch separate unit.

(6) Neither the assets nor the activities of an entity constitutes a foreign branch separate unit.

(7) FS_X is a Country X entity that is subject to Country X tax on its worldwide income or on a residence basis and is classified as a foreign corporation for U.S. tax purposes.

(8) The applicable foreign jurisdiction has a consolidation regime that—

(i) Includes as members of a consolidated group any commonly controlled

branches and permanent establishments in such jurisdiction, and entities that are subject to tax in such jurisdiction on their worldwide income or on a residence basis; and

(ii) Allows the losses of members of consolidated groups to offset income of other members.

(9) There is no mirror legislation, within the meaning of §1.1503(d)-1(b)(14)(v), in the applicable foreign jurisdiction.

(10) There is no elective agreement described in §1.1503(d)-4(b) between the United States and the applicable foreign jurisdiction.

(11) If a domestic use election, within the meaning of §1.1503(d)-4(d), is made, all the necessary filings related to such election are properly completed on a timely basis.

(12) If there is a triggering event requiring recapture of a dual consolidated loss, the amount of recapture is not reduced pursuant to §1.1503(d)-4(h)(2).

(c) *Examples.* The following examples illustrate the application of §§1.1503(d)-1 through 1.1503(d)-4:

Example 1. Separate unit combination rule.

(i) *Facts.* P owns DE3_Y which, in turn, owns DE1_X. DE1_X owns FB_X. Domestic partnership PRS, owned 50% by P and 50% by an unrelated foreign person, conducts operations in Country X that constitute a foreign branch within the meaning of §1.367(a)-6T(g). S owns DE2_X.

(ii) *Result.* Pursuant to §1.1503(d)-1(b)(4)(ii), the interest in DE1_X, FB_X, and P's share of the Country X branch owned by PRS, which is owned by P indirectly through its interest in PRS, are combined and treated as one separate unit owned by P. P's interest in DE3_Y, however, is another separate unit because it is subject to tax in Country Y, rather than Country X. S's interest in DE2_X also is another separate unit because it is owned by S, a different domestic corporation.

Example 2. Domestic use limitation—foreign branch separate unit. (i) *Facts.* P conducts operations in Country X that constitute a permanent establishment under the Country X income tax laws. In Year 1, P's Country X permanent establishment has a loss, as determined under §1.1503(d)-3(b)(2).

(ii) *Result.* Under §1.1503(d)-1(b)(4)(i) and §1.367(a)-6T(g)(1), P's Country X permanent establishment constitutes a foreign branch separate unit. Therefore, the Year 1 loss of the foreign branch separate unit constitutes a dual consolidated loss pursuant to §1.1503(d)-1(b)(5)(ii). The dual consolidated loss rules apply even though there is no affiliate of the foreign branch separate unit in Country X because it is still possible that all or a portion of the dual consolidated loss can be put to a foreign use. For example, there may be a foreign use with respect to an affiliate acquired in a year subsequent to the year in which the dual consolidated loss was generated. Ac-

ordingly, unless an exception under §1.1503(d)-4 applies (such as a domestic use election), the Year 1 dual consolidated loss of P's Country X permanent establishment is subject to the domestic use limitation rule of §1.1503(d)-2(b). As a result, the Year 1 dual consolidated loss cannot offset income of P that is not from its Country X foreign branch separate unit, or income from any other domestic affiliate of such foreign branch separate unit.

Example 3. Domestic use limitation—no foreign consolidation regime. (i) *Facts.* The facts are the same as in *Example 2*, except that Country X does not have a consolidation regime that includes as members of consolidated groups Country X branches or permanent establishments.

(ii) *Result.* The result is the same as *Example 2*. The dual consolidated loss rules apply even in the absence of a consolidation regime in the foreign country because it is possible that all or a portion of a dual consolidated loss can be put to a foreign use by other means, such as through an acquisition or similar transaction.

Example 4. Domestic use limitation—foreign branch separate unit owned through a partnership.

(i) *Facts.* P and S organize a partnership, PRS_X, under the laws of Country X. PRS_X is treated as a partnership for both U.S. and Country X income tax purposes. PRS_X owns FB_X. PRS_X earns U.S. source income that is unconnected with its FB_X branch operations and such income, therefore, is not subject to tax by Country X.

(ii) *Result.* Under §1.1503(d)-1(b)(4)(i), P's and S's shares of FB_X owned indirectly through their interests in PRS_X are foreign branch separate units. Unless an exception under §1.1503(d)-4 applies, any dual consolidated loss incurred by FB_X cannot offset income of P or S (other than income attributable to FB_X), including their distributive share of the U.S. source income earned through their interests in PRS_X, or income of any other domestic affiliates of FB_X.

Example 5. Domestic use limitation—interest in hybrid entity partnership and indirectly owned foreign branch separate unit. (i) *Facts.* HPS_X is a Country X entity that is subject to Country X tax on its worldwide income. HPS_X is classified as a partnership for U.S. tax purposes. P, S, and F_X, an unrelated Country X corporation, are the sole partners of HPS_X. For U.S. tax purposes, P, S, and F_X each has an equal interest in each item of HPS_X's profit or loss. HPS_X conduct operations in Country Y that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of §1.367(a)-6T(g).

(ii) *Result.* Under §1.1503(d)-1(b)(4)(i), the partnership interests in HPS_X held by P and S are hybrid entity separate units. In addition, P's and S's share of the Country Y branch owned indirectly through their interests in HPS_X are foreign branch separate units. Unless an exception under §1.1503(d)-4 applies, dual consolidated losses attributable to P's and S's interests in HPS_X can only be used to offset income attributable to their respective interests in HPS_X (other than income of HPS_X's Country Y foreign branch separate unit). Similarly, dual consolidated losses of P's and S's interests in the Country Y branch of HPS_X can only be used to offset income attributable to their respective interests in the Country Y branch.

Example 6. Foreign use—general rule. (i) *Facts.* P owns DE1_X. DE1_X owns FS_X. In Year 1, DE1_X incurs a \$100x net operating loss for both U.S. and

Country X tax purposes. The \$100x Year 1 loss of DE1_X is attributable to P's interest in DE1_X and is a dual consolidated loss. FS_X earns \$200x of income in Year 1 for Country X tax purposes. DE1_X and FS_X file a Country X consolidated tax return. For Country X purposes, the Year 1 \$100x loss of DE1_X is used to offset \$100x of Year 1 income generated by FS_X.

(ii) *Result.* DE1_X's \$100x loss offsets FS_X's income under the laws of Country X. In addition, under U.S. tax principles, such income is an item of FS_X, a foreign corporation. As a result, under §1.1503(d)-1(b)(14)(i), there has been a foreign use of the Year 1 dual consolidated loss attributable to P's interest in DE1_X. Therefore, P cannot make a domestic use election with respect to the Year 1 dual consolidated loss of DE1_X as provided under §1.1503(d)-4(d)(3)(i), and such loss will be subject to the domestic use limitation rule of §1.1503(d)-2(b). The result would be the same even if FS_X, under Country X laws, had no income against which the dual consolidated loss of DE1_X could be offset (unless FS_X's ability to use the loss under Country X laws requires an election, and no such election is made).

Example 7. Foreign use—foreign reverse hybrid structure. (i) *Facts.* P owns DE1_X. DE1_X owns 99% and S owns 1% of FRH_X, a Country X partnership that elected to be treated as a corporation for U.S. tax purposes. FRH_X conducts an active business in Country X. The 99% interest in FRH_X is the only asset owned by DE1_X. DE1_X's sole item of income, gain, deduction, or loss in Year 1 for purposes of calculating a dual consolidated loss attributable to P's interest in DE1_X is interest expense incurred on a loan from an unrelated party. DE1_X's Year 1 interest expense constitutes a dual consolidated loss. In Year 1, for Country X income tax purposes, DE1_X took into account its distributive share of income generated by FRH_X and offset such income with its interest expense.

(ii) *Result.* In year 1, the dual consolidated loss attributable to P's interest in DE1_X, offsets income recognized in Country X and under U.S. tax principles the income is considered to be income of FRH_X, a foreign corporation. Accordingly, pursuant to §1.1503(d)-1(b)(14)(i), there is a foreign use of the dual consolidated loss. Therefore, P cannot make a domestic use election with respect to DE1_X's Year 1 dual consolidated loss, as provided under §1.1503(d)-4(d)(3)(i), and such loss will be subject to the domestic use limitation rule of §1.1503(d)-2(b).

Example 8. Foreign use—inapplicability of no dilution exception to foreign reverse hybrid structure. (i) *Facts.* The facts are the same as in *Example 7*, except as follows. Instead of owning DE1_X, P owns 75% of HPS_X, a Country X entity subject to Country X tax on its worldwide income. F_X, an unrelated foreign corporation, owns the remaining 25% of HPS_X. HPS_X is classified as a partnership for U.S. income tax purposes. HPS_X owns 99% and S owns 1% of FRH_X. HPS_X incurs the Year 1 interest expense and P's interest in HPS_X, therefore, has a dual consolidated loss in Year 1.

(ii) *Result.* In year 1, the dual consolidated loss attributable to P's interest in HPS_X offsets income recognized under Country X law and under U.S. tax principles the income is considered to be income of FRH_X, a foreign corporation. Accordingly, pursuant

to §1.1503(d)-1(b)(14)(i), there is a foreign use of the dual consolidated loss. In addition, the exception to foreign use under §1.1503(d)-1(b)(14)(iii)(C)(I)(i) does not apply because the foreign use is not solely the result of the dual consolidated loss being made available under Country X laws to offset an item of income or gain recognized under Country X laws that is considered, under U.S. tax principles, to be an item of F_X. Instead, the income that is offset is, under U.S. tax principles, income of FRH_X, a foreign corporation. Therefore, P cannot make a domestic use election with respect to the Year 1 dual consolidated loss attributable to its interest in HPS_X, and such loss will be subject to the domestic use limitation rule of §1.1503(d)-2(b).

Example 9. Foreign use—dual resident corporation with hybrid entity joint venture. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. DRC_X owns 80% of HPS_X, a Country X entity that is subject to Country X tax on its worldwide income. HPS_X is classified as a partnership for U.S. tax purposes. F_X, an unrelated foreign corporation, owns the remaining 20% of HPS_X. In Year 1, DRC_X generates a \$100x net operating loss. Also in Year 1, HPS_X generates \$100x of income for Country X tax purposes. DRC_X and HPS_X file a consolidated tax return for Country X tax purposes, and HPS_X offsets its \$100x of income with the \$100x loss generated by DRC_X.

(ii) *Result.* The \$100x Year 1 net operating loss incurred by DRC_X is a dual consolidated loss. In addition, HPS_X is a hybrid entity and DRC_X's interest in HPS_X is a hybrid entity separate unit; however, there is no dual consolidated loss attributable to such separate unit in Year 1. DRC_X's Year 1 dual consolidated loss offsets \$100x of income for Country X purposes, and \$20x of such amount is (under U.S. tax principles) income of F_X, which owns an interest in HPS_X that is not a separate unit. As a result, pursuant to §1.1503(d)-1(b)(14)(i), there is a foreign use of the Year 1 dual consolidated loss of DRC_X, and P cannot make a domestic use election with respect to such loss pursuant to §1.1503(d)-4(d)(3)(i). Therefore, such loss will be subject to the domestic use limitation rule of §1.1503(d)-2(b).

Example 10. Foreign use—foreign parent corporation. (i) *Facts.* F1 and F2, nonresident alien individuals, each own 50% of FP_X, a Country X entity that is subject to Country X tax on its worldwide income. FP_X is classified as a corporation for U.S. tax purposes. FP_X owns DRC_X. DRC_X is the parent of a consolidated group that includes as a member DS, a domestic corporation. In Year 1, DRC_X generates a dual consolidated loss of \$100x and, for Country X tax purposes, FP_X generates \$100x of income. In Year 1, FP_X elects to consolidate with DRC_X, and the \$100x Year 1 loss of DRC_X is used to offset the income of FP_X under the laws of Country X. For U.S. tax purposes, the items of FP_X do not constitute items of income in Year 1.

(ii) *Result.* The Year 1 dual consolidated loss of DRC_X offsets the income of FP_X under the laws of Country X. Pursuant to §1.1503(d)-1(b)(14)(i), the offset constitutes a foreign use because the items constituting such income are considered under U.S. tax principles to be items of a foreign corporation. This is the case even though the United States does not recognize such items as income in Year 1. Therefore, DRC_X cannot make a domestic use election with respect to its Year 1 dual consolidated loss

pursuant to §1.1503(d)-4(d)(3)(i). As a result, such loss will be subject to the domestic use limitation rule of §1.1503(d)-2(b).

Example 11. Foreign use—parent hybrid entity.

(i) *Facts.* The facts are the same as *Example 10*, except that FP_X is classified as a partnership for U.S. tax purposes.

(ii) *Result.* The dual consolidated loss of DRC_X offsets the income of FP_X under the laws of Country X. Pursuant to §1.1503(d)-1(b)(14)(i), such offset constitutes a foreign use because the items constituting such income are considered under U.S. tax principles to be items of F1 and F2, the owners of interests in FP_X (a hybrid entity), that are not separate units. Therefore, DRC_X cannot make a domestic use election with respect to its Year 1 dual consolidated loss pursuant to §1.1503(d)-4(d)(3)(i). As a result, such loss will be subject to the domestic use limitation rule of §1.1503(d)-2(b). The result would be the same if F1 and F2 owned their interests in FP_X indirectly through another partnership.

Example 12. No foreign use—absence of foreign loss allocation rules. (i) *Facts.* P owns DE1_X and DRC_X. DRC_X is a member of the P consolidated group and owns FS_X. In Year 1, DRC_X incurs a \$200x net operating loss for both U.S. and Country X tax purposes, while DE1_X recognizes \$200x of income in Year 1 under the tax laws of each country. The \$200x loss of DRC_X is a dual consolidated loss. FS_X also earns \$200x of income in Year 1 for Country X tax purposes. DRC_X, DE1_X, and FS_X file a Country X consolidated tax return. However, Country X has no applicable rules for determining which income is offset by DRC_X's Year 1 \$200x loss.

(ii) *Result.* Under §1.1503(d)-1(b)(14)(iii)(B), DRC_X's \$200x loss shall be treated as having been made available to offset DE1_X's \$200x of income. DE1_X is not, under U.S. tax principles, a foreign corporation, and there is no interest in DE1_X that is not a separate unit. As a result, DRC_X's loss being made available to offset the income of DE1_X is not considered a foreign use of such loss. Therefore, P can make a domestic use election with respect to DRC_X's Year 1 dual consolidated loss.

Example 13. No foreign use—absence of foreign loss usage ordering rules. (i) *Facts.* (A) P owns DRC_X, a member of the P consolidated group. DRC_X owns FS_X. Under the Country X consolidation regime, a consolidated group may elect in any given 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 such election is made in a year in which losses are generated by a consolidated member, such losses carry forward and are available, at the election of the consolidated group, to offset income of consolidated group members in subsequent tax years. Country X law does not provide ordering rules for determining when a loss from a particular tax year is used because, under Country X law, losses never expire. Similarly, Country X law does not provide ordering rules for determining when a particular type of loss (for example, capital or ordinary) is used. The United States and Country X recognize the same items of income, gain, deduction and loss in each year. In addition, neither DRC_X nor FS_X has items of income or loss for the taxable year other than those stated below.

(B) In Year 1, DRC_X incurs a capital loss of \$80x which, under §1.1503(d)-3(b)(1), is not a dual con-

solidated loss. DRC_X also incurs a net operating loss of \$80x in Year 1. FS_X generates \$60x of capital gain in Year 1 which, for Country X purposes, can be offset by capital losses and net operating losses. DRC_X elects to use \$60x of its total Year 1 loss of \$160x to offset the \$60x of capital gain generated by FS_X in Year 1; the remaining \$100x of Year 1 loss carries forward. In Year 2, DRC_X incurs a net operating loss of \$100x, while FS_X incurs a net operating loss of \$50x. DRC_X's \$100x loss is a dual consolidated loss. Because DRC_X does not elect under the laws of Country X to use all or a portion of its Year 2 net operating loss of \$100x to offset the income of other members of the Country X consolidated group, P is permitted to make (and in fact does make) a domestic use election with respect to the Year 2 dual consolidated loss of DRC_X. In Year 3, DRC_X has a net operating loss of \$10x and FS_X generates \$60x of capital gains. Country X law permits, upon an election, FS_X's \$60x of capital gain generated in Year 3 to be offset by losses (including carryover losses from prior years) of other group members. Accordingly, in Year 3, DRC_X elects to use \$60x of its accumulated losses to offset the \$60x of Year 3 capital gain generated by FS_X.

(ii) *Result.* (A) DRC_X's \$80x Year 1 net operating loss is a dual consolidated loss. Under the ordering rules of §1.1503(d)-1(b)(14)(iv)(C), a *pro rata* amount of DRC_X's Year 1 net operating loss (\$30x) and capital loss (\$30x) is considered to be used to offset FS_X's Year 1 \$60x capital gain. As a result, P will not be able to make a domestic use election with respect to DRC_X's Year 1 \$80x dual consolidated loss.

(B) DRC_X's \$10x Year 3 net operating loss is also a dual consolidated loss. Under the ordering rules of §1.1503(d)-1(b)(14)(iv)(A), such loss is considered to be used to offset \$10x of FS_X's Year 3 \$60x capital gain. Consequently, P will not be able to make a domestic use election with respect to such loss. Under the ordering rules of §1.1503(d)-1(b)(14)(iv)(B), \$50x of loss carryover from Year 1 will be considered to offset the remaining \$50x of Year 3 income because the income is deemed to have been offset by losses from the earliest taxable year from which a loss can be carried forward or back for foreign law purposes. Thus, none of DRC_X's \$100x Year 2 net operating loss will be deemed to offset FS_X's remaining \$50x of Year 3 income. As a result, such offset will not constitute a foreign use of DRC_X's Year 2 dual consolidated loss.

Example 14. No foreign use—no dilution of an interest in a separate unit. (i) *Facts.* (A) P owns 50% of HPS_X, a Country X entity subject to Country X tax on its worldwide income. F_X, an unrelated foreign corporation, owns the remaining 50% of HPS_X. HPS_X is classified as a partnership for U.S. income tax purposes.

(B) The United States and Country X recognize the same items of income, gain, deduction and loss in Years 1 and 2. In Year 1, HPS_X incurs a loss of \$100x. Under §1.1503(d)-1(b)(4)(i)(B), P's interest in HPS_X is a separate unit and P's interest in HPS_X has a dual consolidated loss of \$50x in Year 1. P makes a domestic use election with respect to such dual consolidated loss. In Year 2, HPS_X generates \$50x of income. Under Country X income tax laws, the \$100x of Year 1 loss incurred by HPS_X is carried forward and offsets the \$50x of income generated by HPS_X in Year 2; the remaining \$50x of loss is carried

forward and is available to offset income generated by HPS_X in subsequent years. P and F_X maintain their 50% ownership interests in HPS_X throughout Years 1 and 2.

(ii) *Result.* In Year 2, under the laws of Country X, the \$100x of Year 1 loss, which includes the \$50x dual consolidated loss attributable to P's interest in HPS_X, is made available to offset income of HPS_X. Such income would be attributable to P's interest in HPS_X, which is a separate unit. Such income would also be income of F_X, an owner of an interest in HPS_X, which is not a separate unit. Under §1.1503(d)-1(b)(14)(iii)(B), because Country X does not have applicable rules for determining which Year 2 income of HPS_X is offset by the \$100x loss carried forward from year 1, the \$50x dual consolidated loss is deemed to first have been made available to offset the \$25x of income attributable to P's interest in HPS_X. However, because only \$25x of income is attributable to P's interest in HPS_X, a portion of the remaining \$25x of the dual consolidated loss is made available (under U.S. tax principles) to offset income of F_X. As a result, a portion of the \$50x dual consolidated loss is made available to offset income of the owner of an interest in a hybrid entity that is not a separate unit and, under the general rule of §1.1503(d)-1(b)(14)(i), there would be a foreign use of P's \$50x Year 1 dual consolidated loss (there would also be a foreign use in this case because F_X is a foreign corporation). However, pursuant to the exception to foreign use under §1.1503(d)-1(b)(14)(iii)(C)(1)(i), there is no foreign use of the Year 1 dual consolidated loss in Year 2. In addition, the exceptions under §1.1503(d)-1(b)(14)(iii)(C)(2) do not apply because P's interest in HPS_X as of the end of Year 1 has not been reduced, and the portion of the \$50x dual consolidated loss was made available for a foreign use in Year 2 solely as a result of F_X's ownership in HPS_X and by the offsetting of income attributable to HPS_X, the partnership in which F_X holds an interest. Therefore, there is no foreign use of the Year 1 dual consolidated loss in Year 2. The result would be the same if F_X owned its interest in HPS_X indirectly through a partnership.

Example 15. Foreign use—dilution of an interest in a separate unit. (i) *Facts.* The facts are the same as Example 14, except that at the beginning of Year 2, F_X contributes cash to HPS_X in exchange for additional equity of HPS_X. As a result of the contribution, F_X's interest in HPS_X increases from 50% to 60%, and P's interest in HPS_X decreases from 50% to 40%.

(ii) *Result.* At the beginning of Year 2, P's interest in HPS_X has been reduced as a result of a person other than a domestic corporation acquiring an interest in HPS_X. Accordingly, pursuant to §1.1503(d)-1(b)(14)(iii)(C)(2)(i), the exception to foreign use provided under §1.1503(d)-1(b)(14)(iii)(C)(1)(i) does not apply. Therefore, in Year 2 there is a foreign use of the \$50x Year 1 dual consolidated loss attributable to P's interest in HPS_X. Such foreign use constitutes a triggering event and the \$50x Year 1 dual consolidated loss is recaptured.

Example 16. No foreign use—dilution by a domestic corporation. (i) *Facts.* The facts are the same as Example 14, except that at the beginning of Year 2, instead of F_X contributing cash to HPS_X, S purchases 20% of P's interest in HPS_X. As a result of the pur-

chase, P's interest in HPS_X decreases from 50% to 40%.

(ii) *Result.* At the beginning of Year 2, P's interest in HPS_X has been reduced as a result of a person acquiring an interest in HPS_X. Accordingly, §1.1503(d)-1(b)(14)(iii)(C)(1)(i) generally does not apply, and there would be a foreign use of the \$50x Year 1 dual consolidated loss attributable to P's interest in HPS_X. However, if P demonstrates, to the satisfaction of the Commissioner, that S is a domestic corporation in a statement attached to, and filed by the due date (including extensions) of P's U.S. income tax return for the taxable year in which the ownership interest of P was reduced, the exception to foreign use under §1.1503-1(b)(14)(iii)(C)(1)(i) will apply. In such a case, there will be no foreign use of the \$50x Year 1 dual consolidated loss attributable to P's interest in HPS_X. The result would be the same if S were unrelated to P, or if S acquired its interest in HPS_X through the contribution of property to HPS_X in exchange for equity (rather than as a purchase of a portion of P's interest).

Example 17. Foreign use—foreign consolidation.

(i) *Facts.* (A) P and F_X, an unrelated Country X corporation, organize HPS_Y. P owns 20% of HPS_Y and F_X owns 80% of HPS_Y. HPS_Y is classified as a partnership for U.S. income tax purposes and is a Country Y entity subject to Country Y tax on its worldwide income. HPS_Y conducts operations in Country X that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of §1.367(a)-6T(g).

(B) In Year 1, the Country X branch of HPS_Y has a loss of \$100x as determined under §1.1503(d)-3(b)(2). Under §1.1503(d)-1(b)(4)(i), P's interest in HPS_Y is a separate unit, and P's indirect interest in a portion of the Country X branch of HPS_Y is also a separate unit. As a result, P has a dual consolidated loss of \$20x in Year 1 attributable to its interest in the Country X branch owned indirectly through HPS_Y. HPS_Y conducts no other activities in Year 1 and has no other items of income, gain, deduction or loss. Accordingly, there is no dual consolidated loss attributable to P's interest in HPS_Y. Under Country X income tax laws, F_X elects to consolidate with the Country X branch of HPS_Y. As a result, the \$100x Year 1 loss of the Country X branch of HPS_Y is available to offset the income of F_X under the laws of Country X through consolidation.

(ii) *Result.* Pursuant to §1.1503(d)-1(b)(14)(iii)(C)(1)(ii), P's Year 1 \$20x dual consolidated loss attributable to its indirect ownership of the Country X branch of HPS_Y would not generally be considered to be made available, under the laws of Country X, to reduce or offset an item of income or gain that is considered under U.S. tax principles to be income of F_X. However, F_X elected to consolidate with the Country X branch under Country X law such that the \$20x dual consolidated loss attributable to P's interest in such separate unit is available to offset income under the laws of Country X as described in §1.1503(d)-1(b)(14)(iii)(C)(2)(ii). As a result, the exception under §1.1503(d)-1(b)(14)(iii)(C)(1)(ii) shall not apply and there is a foreign use of the \$20x Year 1 dual consolidated loss attributable to P's interest in the Country X branch of HPS_Y.

Example 18. No foreign use—no election to consolidate under foreign law. (i) *Facts.* The facts are the same as in Example 17, except that F_X does not elect

under Country X law to consolidate with the Country X branch of HPS_Y.

(ii) *Result.* Because F_X does not elect to consolidate under foreign law, P's dual consolidated loss of \$20x is not made available to offset F_X's income, other than as a result of F_X's ownership of HPS_Y. Accordingly, because there has been no dilution of P's interest in the Country X branch of HPS_Y, there has been no foreign use of P's \$20x Year 1 dual consolidated loss pursuant to §1.1503(d)-1(b)(14)(iii)(C)(1)(ii).

Example 19. No foreign use—combination rule.

(i) *Facts.* (A) P and F_X, an unrelated foreign corporation, form PRS_X. P and F_X each own 50 percent of PRS_X throughout Years 1 and 2. PRS_X is treated as a partnership for both U.S. and Country X income tax purposes. PRS_X owns DE_Y. DE_Y is a Country Y entity subject to Country Y tax on its worldwide income and disregarded as an entity separate from its owner for U.S. tax purposes. PRS_X does not have any items of income, gain, deduction, or loss from sources other than DE_Y. P also owns FB_Y, a Country Y foreign branch separate unit. Pursuant to Country Y law, the losses of DE_Y are available to offset the income of FB_Y, and vice versa. Under §1.1503(d)-1(b)(4)(i), P's interest in DE_Y, owned indirectly through PRS_X, is a hybrid entity separate unit. In addition, under §1.1503(d)-1(b)(4)(ii), FB_Y and P's indirect interest in DE_Y are treated as a combined separate unit.

(B) The United States and Country Y recognize the same items of income, gain, deduction and loss in Years 1 and 2. In year 1, DE_Y incurs a \$100x loss and FB_Y incurs a \$200x loss. Under §1.1503(d)-3(b)(vii)(B), the dual consolidated loss attributable to P's combined separate unit is \$250x (\$50x loss attributable to P's indirect interest in DE_Y plus \$200x loss of FB_Y). In Year 2, DE_Y generates no income or loss.

(ii) *Result.* Under Country Y law, the \$100x of Year 1 loss incurred by DE_Y is carried forward and is available to offset income of DE_Y in Year 2. As a result, a portion of such loss will be available to offset income of DE_Y that is attributable to P's interest in DE_Y owned indirectly through PRS_X. A portion of such loss will also be available to offset income of DE_Y that is attributable to F_X's indirect ownership of DE_Y. Accordingly, under §1.1503(d)-1(b)(14)(i), there would be a foreign use of a portion of P's \$250x Year 1 dual consolidated loss because it is available to offset an item of income of the owner of an interest in a hybrid entity, which is not a separate unit (there would also be a foreign use in this case because F_X is a foreign corporation). However, under §1.1503(d)-1(b)(14)(iii)(C)(1)(ii) and (iii), and because there has been no dilution of P's interest in DE_Y (and no consolidation of DE_Y), no foreign use occurs as a result of the carryforward.

Example 20. Mirror legislation rule—dual resident corporation.

(i) *Facts.* P owns DRC_X, a member of the P consolidated group. DRC_X owns FS_X. In Year 1, DRC_X generates a \$100x net operating loss that is a dual consolidated loss. To prevent corporations like DRC_X from offsetting losses both against income of affiliates in Country X and against income of foreign affiliates under the tax laws of another country, Country X mirror legislation prevents a corporation that is subject to the income tax of another country on its worldwide income or on a residence basis from using the Country X form of consolida-

tion. Accordingly, the Country X mirror legislation prevents the loss of DRC_X from being made available to offset income of FS_X.

(ii) *Result.* Under §1.1503(d)-1(b)(14)(v), because the losses of DRC_X are subject to Country X's mirror legislation, there shall, other than for purposes of the consistency rule under §1.1503(d)-4(d)(2), be a deemed foreign use of DRC_X's Year 1 dual consolidated loss. Therefore, P will not be able to make a domestic use election with respect to DRC_X's Year 1 dual consolidated loss pursuant to §1.1503(d)-4(d)(3)(i).

Example 21. Mirror legislation rule—standalone foreign branch separate unit. (i) *Facts.* P owns FB_X. In Year 1, FB_X incurs a dual consolidated loss of \$100x. Under Country X tax laws, FB_X also generates a loss. Country X enacted mirror legislation to prevent Country X branches of nonresident corporations from offsetting losses both against income of Country X affiliates and against other income of its owner (or foreign affiliate thereof) under the tax laws of another country. The Country X mirror legislation prevents a Country X branch of a nonresident corporation from offsetting its losses against the income of Country X affiliates if such losses may be deductible against income (other than income of the Country X branch) under the laws of another country.

(ii) *Result.* Under §1.1503(d)-1(b)(14)(v), because the losses of FB_X are subject to Country X's mirror legislation, there shall, other than for purposes of the consistency rule under §1.1503(d)-4(d)(2), be a deemed foreign use of FB_X's Year 1 dual consolidated loss. This is the result even though P has no Country X affiliates. Therefore, P cannot make a domestic use election with respect to the Year 1 dual consolidated loss of FB_X pursuant to §1.1503(d)-4(d)(3)(i).

Example 22. Mirror legislation rule—absence of election to file consolidated return under local law.

(i) *Facts.* The facts are the same as in *Example 21*, except that P also owns FS_X and no election is made under Country X law to consolidate FB_X and FS_X.

(ii) *Result.* The result is the same as *Example 21*, even though FB_X has a Country X affiliate and no election is made under Country X law to consolidate FB_X and FS_X.

Example 23. Mirror legislation rule—inapplicability to particular dual resident corporation or separate unit. (i) *Facts.* The facts are the same as in *Example 21*, except as follows. Rather than conducting operations in Country X through a foreign branch, P owns DE1_X. In Year 1, DE1_X incurs a loss of \$100x and also generates a loss for Country X tax purposes. The \$100x Year 1 loss of DE1_X is a dual consolidated loss attributable to P's interest in DE1_X.

(ii) *Result.* The Country X mirror legislation only applies to Country X branches owned by non-resident corporations and therefore does not apply to losses generated by DE1_X. Thus, if DE1_X had a Country X affiliate, it would be permitted under the laws of Country X to use its loss to offset income of such affiliate, notwithstanding the Country X mirror legislation. As a result, the mirror legislation rule under §1.1503(d)-1(b)(14)(v) does not apply with respect to the Year 1 dual consolidated loss of P's interest in DE1_X. Therefore, a domestic use election can be made with respect to such loss (provided the conditions for such an election are otherwise satisfied).

Example 24. Dual consolidated loss limitation after section 381 transaction—disposition of assets and subsequent liquidation of dual resident corporation. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. In Year 1, DRC_X incurs a dual consolidated loss and P does not make a domestic use election with respect to such loss. Under §1.1503(d)-2(b), DRC_X's Year 1 dual consolidated loss may not be used to offset the income of P or S (or the income of any other domestic affiliate of DRC_X) on the group's consolidated U.S. income tax return. At the beginning of Year 2, DRC_X sells all of its assets and discontinues its business operations. DRC_X is then liquidated into P pursuant to section 332.

(ii) *Result.* Typically, under section 381, P would succeed to, and be permitted to utilize, DRC_X's net operating loss carryover. However, §1.1503(d)-2(c)(1)(i) prohibits the dual consolidated loss of DRC_X from carrying over to P. Therefore, DRC_X's Year 1 net operating loss carryover is eliminated.

Example 25. Dual consolidated loss limitation after section 381 transaction—liquidation of dual resident corporation. (i) *Facts.* The facts are the same as in *Example 24*, except as follows. DRC_X's activities constitute a foreign branch within the meaning of §1.367(a)-6T(g) and therefore are a foreign branch separate unit. In addition, DRC_X's foreign branch separate unit incurs the Year 1 dual consolidated loss, rather than DRC_X itself. Finally, DRC_X does not sell its assets and, following the liquidation of DRC_X, P continues to operate DRC_X's business as a foreign branch separate unit.

(ii) *Result.* Pursuant to §1.1503(d)-2(c)(2)(iii), DRC_X's Year 1 loss carryover is available to offset P's income generated by the foreign branch separate unit previously owned by DRC_X (and now owned by P), subject to the limitations of §1.1503(d)-3(c) applied as if the separate unit of P generated the dual consolidated loss.

Example 26. Tainted income. (i) *Facts.* P owns 100% of DRC_Z, a domestic corporation that is included as a member of the P consolidated group. The P consolidated group uses the calendar year as its taxable year. During Year 1, DRC_Z was managed and controlled in Country Z and therefore was subject to tax as a resident of Country Z and was a dual resident corporation. In Year 1, DRC_Z generated a dual consolidated loss of \$200x, and P did not make a domestic use election with respect to such loss. As a result, such loss is subject to the domestic use limitation rule of §1.1503(d)-2(b). At the end of Year 1, DRC_Z moved its management and control from Country Z to the United States and therefore ceased being a dual resident corporation. At the beginning of Year 2, P transferred asset A, a non-depreciable asset, to DRC_Z in exchange for common stock in a transaction that qualified for nonrecognition under section 351. At the time of the transfer, P's tax basis in asset A equaled \$50x and the fair market value of asset A equaled \$100x. The tax basis of asset A in the hands of DRC_Z immediately after the transfer equaled \$50x pursuant to section 362. Asset A did not constitute replacement property acquired in the ordinary course of business. DRC_Z did not generate income or gain during Years 2, 3 or 4. On June 30, Year 5, DRC_Z sold asset A to a third party for \$100x, its fair market value at the time of the sale, and recognized \$50x of income on such sale. In addition to the \$50x income gener-

ated on the sale of asset A, DRC_Z generated \$100x of operating income in Year 5. At the end of Year 5, the fair market value of all the assets of DRC_Z was \$400x.

(ii) *Result.* DRC_Z ceased being a dual resident corporation at the end of Year 1. Therefore, its Year 1 dual consolidated loss cannot be offset by tainted income. Asset A is a tainted asset because it was acquired in a nonrecognition transaction after DRC_Z ceased being a dual resident corporation (and was not replacement property acquired in the ordinary course of business). As a result, the \$50x of income recognized by DRC_Z on the disposition of asset A is tainted income and cannot be offset by the Year 1 dual consolidated loss of DRC_Z. In addition, absent evidence establishing the actual amount of tainted income, \$25x of the \$100x Year 5 operating income of DRC_Z (((\$100x/\$400x) x \$100x)) also is treated as tainted income and cannot be offset by the Year 1 dual consolidated loss of DRC_Z under §1.1503(d)-2(d)(2)(ii). Therefore, \$75x of the \$150x Year 5 income of DRC_Z constitutes tainted income and may not be offset by the Year 1 dual consolidated loss of DRC_Z; however, the remaining \$75x of Year 5 income of DRC_Z may be offset by such dual consolidated loss.

Example 27. Treatment of disregarded item. (i) *Facts.* P owns DE1_X. In Year 1, DE1_X incurs interest expense attributable to a loan made from P to DE1_X. DE1_X has no other items of income, gain, deduction, or loss in Year 1. Because DE1_X is disregarded as an entity separate from its owner, however, the interest expense is disregarded for federal tax purposes.

(ii) *Result.* Even though DE1_X is treated as a separate domestic corporation for purposes of determining the amount of dual consolidated loss pursuant to §1.1503(d)-3(b)(2)(i), such treatment does not cause the interest expense incurred on the loan from P to DE1_X that is disregarded for federal tax purposes to be regarded for purposes of calculating the Year 1 dual consolidated loss, if any, of DE1_X. Therefore, P's interest in DE1_X does not have a dual consolidated loss in Year 1.

Example 28. Hybrid entity books and records. (i) *Facts.* P owns DE1_X. In Year 1, P incurs interest expense attributable to a loan from a third party. The third party loan and related interest expense are properly recorded on the books and records of P (and not on the books and records of DE1_X).

(ii) *Result.* The interest expense on P's loan from the third party is not properly recorded on the books and records of DE1_X. No portion of the interest expense on such loan is attributable to DE1_X pursuant to §1.1503(d)-3(b)(2)(iii) and (iv). Therefore, no portion of the interest expense is taken into account for purposes of calculating the Year 1 dual consolidated loss, if any, attributable to P's interest in DE1_X pursuant to §1.1503(d)-3(b)(2).

Example 29. Dividend income attributable to a separate unit. (i) *Facts.* P owns DE1_X. DE1_X owns DE3_Y. DE3_Y owns CFC, a controlled foreign corporation. P's interest in DE1_X would otherwise have a dual consolidated loss of \$75x (without regard to Year 1 dividend income or section 78 gross-up received from CFC) in Year 1. In Year 1, CFC distributes \$50x to DE3_Y, that is taxable as a dividend. DE3_Y distributes the same amount to DE1_X. P computes foreign taxes deemed paid on the dividend un-

der section 902 of \$25x and includes that amount in gross income under section 78 as a dividend.

(ii) *Result.* The \$75x of dividend income (\$50x distribution plus \$25x section 78 gross-up) is properly recorded on the books and records of DE3_Y, as adjusted to conform to U.S. tax principles. Accordingly, for purposes of determining whether the interest in DE3_Y has a dual consolidated loss, the \$75x dividend income from CFC is an item of income attributable to DE3_Y, a disregarded entity, and therefore is an item attributable to the interest in DE3_Y. The distribution of \$50x from DE3_Y to DE1_X is generally not regarded for tax purposes and therefore does not give rise to an item that is taken into account for purposes of calculating a dual consolidated loss. As a result, the dual consolidated loss of \$75x attributable to P's interest in DE1_X in Year 1 is not reduced by the amount of dividend income attributable to the interest in DE3_Y.

Example 30. Items attributable to a combined separate unit. (i) *Facts.* P owns DE1_X. DE1_X owns a 50% interest in PRS_Z, a Country Z entity that is classified as a partnership both for Country Z tax purposes and for U.S. tax purposes. F_Z, a Country Z corporation unrelated to P, owns the remaining 50% interest in PRS_Z. PRS_Z conducts operations in Country X that, if owned by a U.S. person, would constitute a foreign branch as defined in §1.367(a)-6T(g). Therefore, P's share of the Country X branch owned by PRS_Z constitutes a foreign branch separate unit. PRS_Z also owns assets that do not constitute a part of its Country X branch.

(ii) *Result.* (A) Pursuant to §1.1503(d)-1(b)(4)(ii), P's interest in DE1_X, and P's indirect ownership of a portion of the Country X branch of PRS_Z, are combined and treated as one Country X separate unit. Pursuant to §1.1503(d)-3(b)(2)(vii)(B)(I), for purposes of determining P's items of income, gain, deduction and loss taken into account by its combined separate unit, the items of P are first attributed to each separate unit that compose the combined Country X separate unit.

(B) Pursuant to §1.1503(d)-3(b)(2)(ii)(A), the principles of section 864(c)(2), as modified, apply for purposes of determining P's items of income, gain, deduction (other than interest expense) and loss that are taken into account in determining the taxable income or loss of P's indirect interest in the Country X foreign branch owned by PRS_Z. For purposes of determining interest expense taken into account in determining the taxable income or loss of P's indirect interest in the Country X foreign branch owned by PRS_Z, the principles of §1.882-5, subject to §1.1503(d)-3(b)(2)(ii)(B). For purposes of applying the principles of section 864(c) and §1.882-5, P is treated as a foreign corporation, the Country X branch of PRS_Z is treated as a trade or business within the United States, and the assets of P (other than those of FB_X) are treated as assets that are not U.S. assets. In addition, pursuant to §1.1503(d)-3(b)(2)(vii)(A)(I), only the items of DE1_X and PRS_Z are taken into account for purposes of this determination.

(C) For purposes of determining the items of income, gain, deduction and loss that are attributable

to DE1_X and, therefore, attributable to P's interest in DE1_X, only those items that are properly reflected on the books and records of DE1_X, as adjusted to conform to U.S. tax principles, are taken into account. For this purpose, DE1_X's distributive share of the items of income, gain, deduction and loss that are properly reflected on the books and records of PRS_Z, as adjusted to conform to U.S. tax principles, are treated as being reflected on the books and records of DE1_X, except to the extent such items are taken into account by the Country X branch of PRS_Z, as provided above.

(D) Pursuant to §1.1503(d)-3(b)(2)(vii)(B)(2), the combined Country X separate unit of P calculates its dual consolidated loss by taking into account all the items of income, gain deduction and loss that were separately taken into account by P's interest in DE1_X and the Country X branch of PRS_Z owned indirectly by P.

Example 31. Sale of branch by domestic owner. (i) *Facts.* P owns FB_X. FB_X has a \$100x dual consolidated loss in Year 1. P makes a domestic use election with respect to such dual consolidated loss. In Year 2, P sells FB_X and recognizes \$75x of gain as a result of such sale. The sale is a triggering event of the Year 1 dual consolidated loss under §1.1503(d)-4(e)(1).

(ii) *Result.* Pursuant to §1.1503(d)-3(b)(2)(vii)(C), the gain on the sale of FB_X is attributable to FB_X for purposes of calculating the Year 2 dual consolidated loss (if any) of FB_X, and for purposes of determining FB_X's Year 2 taxable income for purposes of rebutting the amount of the Year 1 dual consolidated loss to be recaptured pursuant to §1.1503(d)-4(h)(2)(i). Assuming FB_X has no other items of income, gain, deduction and loss in Year 2, only \$25x of the Year 1 dual consolidated loss must be recaptured.

Example 32. Sale of separate unit by another separate unit. (i) *Facts.* P owns DE1_X. DE1_X owns DE3_Y. DE1_X sells its interest in DE3_Y at the end of Year 1 to an unrelated third party. The sale resulted in an ordinary loss of \$30x. Without regard to the sale of DE3_Y, no items of income, gain, deduction or loss are attributable to the interest of DE3_Y in Year 1.

(ii) *Result.* Pursuant to §1.1503(d)-3(b)(2)(vii)(C), the \$30x loss recognized on the sale is attributable to the interest in DE3_Y, and not the interest in DE1_X. In addition, the loss attributable to the sale creates a Year 1 dual consolidated loss attributable to the interest in DE3_Y. Pursuant to §1.1503(d)-4(d)(3)(i), P cannot make a domestic use election with respect to the Year 1 dual consolidated loss attributable to the interest in DE3_Y because the sale of the interest in DE3_Y is described in §1.1503(d)-4(e)(1). As a result, although the Year 1 dual consolidated loss would otherwise be subject to the domestic use limitation rule of §1.1503(d)-2(b), it is eliminated pursuant to §1.1503(d)-2(c)(1)(ii).

Example 33. Gain and loss on sale of tiered separate units. (i) *Facts.* P owns DE1_X. DE1_X owns DE3_Y. P sells its interest in DE1_X to an unrelated third party. As a result of this sale, P recognizes \$25x of net gain, consisting of \$75 of income and \$50 of loss. If DE1_X sold its assets in a taxable transaction immediately before the sale of P's interest in DE1_X, DE1_X

would have recognized \$75x of income. In addition, if DE3_Y had sold its assets in a taxable transaction immediately before the sale of P's interest in DE1_X, DE3_Y would have recognized a \$50x loss.

(ii) *Result.* Pursuant to §1.1503(d)-3(b)(2)(vii)(C), the \$75x of income and \$50x of loss must be allocated to the interests of DE1_X and DE3_Y based on the amount of gain or loss that would be recognized if such entities sold their assets in a taxable exchange for an amount equal to their fair market value immediately before P sold its interest in DE1_X. Therefore, \$75x of gain and \$50x of loss recognized by P on the sale of its interest DE1_X are attributable to the interests in DE1_X and DE3_Y, respectively. As a result, such items will be taken into account in determining whether an interest in either entity has a dual consolidated loss in the year of the sale and for purposes of rebutting the amount of recapture of any dual consolidated loss (for which a domestic use election was made) of DE1_X from a prior year, if any, pursuant to §1.1503(d)-4(h)(2)(i).

Example 34. Gain on sale of tiered separate units.

(i) *Facts.* P owns 75% of HPS_X, a Country X entity subject to Country X tax on its worldwide income. F_X, an unrelated foreign corporation, owns the remaining 25% of HPS_X. HPS_X is classified as a partnership for U.S. income tax purposes. HPS_X owns operations in Country Y that, if owned by a U.S. person, would constitute a foreign branch within the meaning of §1.367(a)-6T(g). HPS_X also owns assets that do not constitute a part of its Country Y branch. P's indirect interest in the Country Y branch owned by HPS_X, and P's interest in HPS_X, are each separate units. P sells its interest in HPS_X and recognizes a gain of \$150x on such sale. Immediately prior to P's sale of its interest in HPS_X, P's indirect interest in HPS_X's Country Y branch had a net built-in gain of \$200x, and P's *pro rata* portion of HPS_X's other assets had a net built-in gain of \$100x.

(ii) *Result.* Pursuant to §1.1503(d)-3(b)(2)(vii)(C), \$100x of the total \$150x of gain recognized (\$200x/\$300x x \$150x) is taken into account for purposes of determining the taxable income of P's indirect interest in its share of the Country Y branch owned by HPS_X. Thus, such amount will be taken into account in determining whether it has a dual consolidated loss in the year of the sale and for purposes of rebutting the amount of dual consolidated loss recapture, if any, pursuant to §1.1503(d)-4(h)(2)(i). Similarly, \$50x of such gain (\$100x/\$300x x \$150x) is attributable to P's interest in HPS_X and will be taken into account in determining whether it has a dual consolidated loss in the year of sale, and for purposes of rebutting the amount of recapture, if any, pursuant to §1.1503(d)-4(h)(2)(i).

Example 35. Effect on domestic affiliate. (i) *Facts.* (A) P owns DE1_X. In Years 1 and 2, the items of income, gain, deduction, and loss that are attributable to P's interest in DE1_X for purposes of determining whether such interest has a dual consolidated loss for each year, pursuant to §1.1503(d)-3(b)(2), are as follows:

| Item | Year 1 | Year 2 |
|-----------------------------------|---------|---------|
| Sales income | \$100x | \$160x |
| Salary expense | (\$75x) | (\$75x) |
| Research and experimental expense | (\$50x) | (\$50x) |
| Interest expense | (\$25x) | (\$25x) |
| Income/(dual consolidated loss) | (\$50x) | (\$10x) |

(B) P does not make a domestic use election with respect to DE1_X's Year 1 dual consolidated loss. Pursuant to §§1.1503(d)-2(b) and 1.1503(d)-3(c)(2), DE1_X's Year 1 dual consolidated loss of \$50x is treated as a loss incurred by a separate corporation and is subject to the limitations under §1.1503(d)-3(c)(3).

(ii) *Result.* (A) P must compute its taxable income for Year 1 without taking into account the \$50x dual consolidated loss attributable to P's interest in DE1_X. Such amount consists of a *pro rata* portion of the expenses that were taken into account by DE1_X in calculating its Year 1 dual consolidated loss. Thus, the items of the dual consolidated loss that are not taken into account by P in computing its taxable income are as follows: \$25x of salary expense (\$75x/\$150x x \$50x); \$16.67x of research and experimental expense (\$50x/\$150x x \$50x); and \$8.33x of interest expense (\$25x/\$150x x \$50x). The remaining amounts of each of these items, together with the \$100x of sales income, are taken into account by P in computing its taxable income for Year 1 as follows: \$50x of salary expense (\$75x - \$25x); \$33.33x of research and experimental expense (\$50x - \$16.67x); and \$16.67x of interest expense (\$25x - \$8.33x).

(B) Subject to the limitations provided under §1.1503(d)-3(c)(3), the \$50x dual consolidated loss generated by DE1_X in Year 1 is carried forward and is available to offset the \$10x of income generated by DE1_X in Year 2. A *pro rata* portion of each item of deduction or loss included in such dual consolidated loss is considered to be used to offset the \$10x of income, as follows: \$5x of salary expense (\$25x/\$50x x \$10x); \$3.33x of research and experimental expense (\$16.67x/\$50x x \$10x); and \$1.67x of interest expense (\$8.33x/\$50x x \$10x). The remaining amount of each item shall continue to be subject to the limitations under §1.1503(d)-3(c)(3).

Example 36. Basis adjustment rule—year of dual consolidated loss. (i) *Facts.* (A) In addition to S, P owns S1, a domestic corporation. S owns DRC_X and DRC_X, in turn, owns FS_X. S, S1 and DRC_X are each members of the P consolidated group. W and Y are

unrelated corporations that are not members of the P consolidated group.

(B) At the beginning of Year 1, P has a basis of \$1,000x in the stock of S. S has a \$500x basis in the stock of DRC_X.

(C) In Year 1, DRC_X incurs interest expense in the amount of \$100x. In addition, DRC_X sells a noncapital asset, u, in which it has a basis of \$10x, to S1 for \$50x. DRC_X also sells a noncapital asset, v, in which it has a basis of \$200x, to S1 for \$100x. The sales of u and v are intercompany transactions described in §1.1502-13. DRC_X also sells a capital asset, z, in which it has a basis of \$180x, to Y for \$90x. In Year 1, S1 earns \$200x of separate taxable income, calculated in accordance with §1.1502-12, as well as \$90x of capital gain from a sale of an asset to W. P and S have no items of income, gain, deduction or loss for Year 1.

(D) In Year 1, DRC_X has a dual consolidated loss of \$100x (attributable to its interest expense). The sale of non-capital assets u and v to S1, which are intercompany transactions, are not taken into account in calculating DRC_X's dual consolidated loss. Pursuant to §1.1503(d)-3(b)(1), DRC_X's \$90x capital loss also is not included in the computation of the dual consolidated loss. Instead, DRC_X's capital loss is included in the computation of the consolidated group's capital gain net income under §1.1502-22(c) and is used to offset S1's \$90x capital gain.

(E) For Country X tax purposes, DRC_X's \$100x loss is available to offset the income of FS_X, a foreign corporation, and therefore constitutes a foreign use. As a result, DRC_X is not eligible to make a domestic use election pursuant to §1.1503(d)-4(d), and the \$100x Year 1 dual consolidated loss of DRC_X is subject to the domestic use limitation rule of §1.1503(d)-2(b).

(ii) *Result.* (A) Because DRC_X has a dual consolidated loss for the year, the consolidated taxable income of the consolidated group is calculated without regard to DRC_X's items of loss or deduction taken into account in computing its dual consolidated loss (that is, the \$100x of interest expense). Therefore,

the consolidated taxable income of the consolidated group is \$200x (the sum of \$200x of separate taxable income earned by S1, plus \$90x of capital gain earned by S1, minus \$90x of capital loss incurred by DRC_X). The \$40x gain of DRC_X upon the sale of item u to S1, and the \$100x loss of DRC_X upon the sale of item v to S1, are deferred pursuant to §1.1502-13(c).

(B) Pursuant to §1.1503(d)-3(d)(1)(i), S must make a negative adjustment under §1.1502-32(b)(2) to its basis in the stock of DRC_X for the \$100x dual consolidated loss incurred by DRC_X. In addition, S must make a negative adjustment under §1.1502-32(b)(2) in the basis of the DRC_X stock for DRC_X's \$90x capital loss because the loss has been absorbed by the consolidated group. Thus, S must make a \$190x net negative adjustment to its basis in the stock of DRC_X, reducing its basis from \$500x to \$310x. As provided in §1.1502-32(a)(3)(iii), the adjustments in the DRC_X stock made by S are taken into account in determining P's basis in its S stock. Since S has no items of income, gain, deduction or loss for the taxable year, P must only make a negative adjustment to its basis in the stock of S to account for the tiering-up of adjustments for the taxable year pursuant to §1.1502-32(a)(3)(iii). Thus, P must make a \$190x net negative adjustment to its basis in S stock, reducing its basis from \$1,000x to \$810x.

Example 37. Basis adjustment rule—subsequent income of dual resident corporation. (i) *Facts.* (A) The facts are the same as in *Example 36*, except as follows. In Year 2, S1 sells items u and v to W for no gain or loss. The disposition of items u and v outside of the P consolidated group causes the intercompany gain and loss of DRC_X attributable to u and v to be taken into account pursuant to §1.1502-13(c). DRC_X also incurs \$100x of interest expense in Year 2. In addition, DRC_X sells a noncapital asset, r, in which it has a basis of \$100x, to Y for \$300x. P and S have no items of income, loss, or deduction for Year 2.

(B) DRC_X has \$40x of separate taxable income in Year 2, computed as follows:

| | |
|----------------------|----------|
| Interest Expense | (\$100x) |
| Sale of Item v to S1 | (\$100x) |
| Sale of Item u to S1 | \$40x |
| Sale of Item r to Y | \$200x |
| Net Income/(Loss) | \$40x |

(C) Since DRC_X does not have a dual consolidated loss for Year 2, the group's consolidated taxable income for the year is calculated in accordance with the general rule of §1.1502-11, and not in accordance with §1.1503(d)-3(c). In addition, DRC_X 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 DRC_X's dual consolidated loss carryover, is \$40x.

(ii) *Result.* (A) As provided under §1.1503(d)-3(c), the portion of the \$100x dual consolidated loss arising in Year 1 that is included in the group's consolidated net operating loss deduction for Year 2 is

\$40x. Thus, the P group has no consolidated taxable income for the year.

(B) Pursuant to §1.1503(d)-3(d)(1)(ii), S does not make a negative adjustment to its basis in DRC_X stock for the \$40x of Year 1 dual consolidated loss that is absorbed in Year 2. However, pursuant to §1.1502-32(b), S does make a \$40x net positive ad-

justment to its basis in DRC_X stock, increasing its basis from \$310x to \$350x. In addition, as provided in §1.1502-32(a)(3)(iii), the adjustments in the DRC_X stock made by S are taken into account in determining P's basis in its S stock. Since S has no other items of income, gain, deduction or loss for the taxable year, P must only make a positive adjustment to its basis in the stock of S for to account for the tiering-up of adjustments for the taxable year pursuant to §1.1502-32(a)(3)(iii). Thus, P must make a \$40x net positive adjustment to its basis in S stock, increasing its basis from \$810x to \$850x.

Example 38. Exception to domestic use limitation—no possibility of foreign use because items are not deducted or capitalized under foreign law. (i) *Facts.* P owns DE1_X. In Year 1, the sole item of income, gain, deduction or loss attributable to P's interest in DE1_X as provided under §1.1503(d)-3(b)(2) is \$100x of interest expense. For Country X tax purposes, the \$100x interest expense attributable to P's interest in DE1_X in Year 1 is treated as a repayment of principal and therefore cannot be deducted (at any time) or capitalized.

(ii) *Result.* The \$100x of interest expense attributable to P's interest in DE1_X constitutes a dual consolidated loss. However, because the sole item constituting the dual consolidated loss cannot be deducted or capitalized for Country X tax purposes, P can demonstrate that there can be no foreign use of the dual consolidated loss at any time. As a result, pursuant to §1.1503(d)-4(c)(1), if P prepares a statement described in §1.1503(d)-4(c)(2) and attaches it to its timely filed tax return, the Year 1 dual consolidated loss of DE1_X will not be subject to the domestic use limitation rule of §1.1503(d)-2(b).

Example 39. No exception to domestic use limitation— inability to demonstrate no possibility of foreign use because items are deferred under foreign law. (i) *Facts.* P owns DE1_X. In Year 1, the sole items of income, gain, deduction or loss attributable to P's interest in DE1_X as provided under §1.1503(d)-3(b)(2) are \$75x of sales income and \$100x of depreciation expense. For Country X tax purposes, DE1_X also generates \$75x of sales income in Year 1, but the \$100x of depreciation expense is not deductible in Year 1. Instead, for Country X tax purposes the \$100x of depreciation expense is deductible in Year 2. P does not make a domestic use election with respect to the Year 1 dual consolidated loss attributable to P's interest in DE1_X.

(ii) *Result.* The Year 1 \$25x net loss of DE1_X constitutes a dual consolidated loss attributable to P's interest in DE1_X. In addition, even though DE1_X has positive income in Year 1 for Country X tax purposes, P cannot demonstrate that there is no possibility of foreign use of its dual consolidated loss as provided under §1.1503(d)-4(c)(1)(i). P cannot make such a demonstration because the depreciation expense, an item composing the Year 1 dual consolidated loss, is deductible (in a later year) for Country X tax purposes and, therefore, may be available to offset or reduce income for Country X purposes that would constitute a foreign use. For example, if DE1_X elected to be classified as a corporation pursuant to §301.7701-3(c) of this chapter effective as of the end of Year 1, and the deferred depreciation expense were available for Country X tax purposes to offset Year 2 income of DE1_X, an entity treated as a foreign corporation in Year 2 for U.S. tax purposes, there would be a foreign

use. P could, however, make a domestic use election pursuant to §1.1503(d)-4(d) with respect to the Year 1 dual consolidated loss.

Example 40. No exception to domestic use limitation— inability to demonstrate no possibility of foreign use because items are deferred and not deducted or capitalized under foreign law. (i) *Facts.* P owns DE1_X. In Year 1, the sole items of income, gain, deduction or loss attributable to P's interest in DE1_X as provided in §1.1503(d)-3(b)(2) are \$75x of sales income, \$100x of interest expense and \$25x of depreciation expense. For Country X tax purposes, DE1_X generates \$75x of sales income in Year 1, but the \$100x interest expense is treated as a repayment of principal and therefore cannot be deducted (at any time) or capitalized. In addition, for Country X tax purposes the \$25x of depreciation expense is not deductible in Year 1, but is deductible in Year 2.

(ii) *Result.* The Year 1 \$50x net loss of DE1_X constitutes a dual consolidated loss attributable to P's interest in DE1_X. Even though the \$100x interest expense, a non-deductible and noncapital item for Country X tax purposes, exceeds the \$50x Year 1 dual consolidated loss of DE1_X, P cannot demonstrate that there is no possibility of foreign use of the dual consolidated loss as provided under §1.1503(d)-4(c)(1)(i). P cannot make such a demonstration because the \$25x depreciation expense, an item of deduction or loss composing the Year 1 dual consolidated loss, is deductible under Country X law (in Year 2) and, therefore, may be available to offset or reduce income for Country X purposes that would constitute a foreign use. P could, however, make a domestic use election pursuant to §1.1503(d)-4(d) with respect to the Year 1 dual consolidated loss.

Example 41. Consistency rule—deemed foreign use. (i) *Facts.* P owns DRC_X, a member of the P consolidated group, FB_X, and FS_X. In Year 1, DRC_X incurs a dual consolidated loss, which is used to offset the income of FS_X under the Country X form of consolidation. FB_X also incurs a dual consolidated loss in Year 1. However, P elects not to use the FB_X loss on a Country X consolidated return to offset the income of Country X affiliates.

(ii) *Result.* The use of DRC_X's dual consolidated loss to offset the income of FS_X for Country X purposes constitutes a foreign use. Pursuant to §1.1503(d)-4(d)(2), this foreign use results in a foreign use of the dual consolidated loss of FB_X. Therefore, the dual consolidated loss attributable to FB_X is subject to the domestic use limitation rule of §1.1503(d)-2(b), and P cannot make a domestic use election with respect to such loss.

Example 42. Consistency rule—no foreign use permitted. (i) *Facts.* The facts are the same as in Example 41, except that the income tax laws of Country X do not permit Country X branches of foreign corporations to file consolidated income tax returns with Country X affiliates.

(ii) *Result.* The consistency rule does not apply with respect to the dual consolidated loss of FB_X because the income tax laws of Country X do not permit a foreign use for such dual consolidated loss. Therefore, P may make a domestic use election for the dual consolidated loss attributable to FB_X.

Example 43. Triggering event rebuttal—expiration of losses in foreign country. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. In Year 1, DRC_X incurs a dual consolidated loss of

\$100x. P makes a domestic use election with respect to DRC_X's Year 1 dual consolidated loss and such loss therefore is included in the computation of the P group's consolidated taxable income. DRC_X has no income or loss in Year 2 through Year 6. In Year 7, P sells the stock of DRC_X to an unrelated party. At the time of the sale of the stock of DRC_X, all of the losses and deductions that were included in the computation of the Year 1 dual consolidated loss of DRC_X had expired for Country X purposes because the laws of Country X only provide for a five year carryover period of such items.

(ii) *Result.* The sale of DRC_X to the unrelated party generally would be a triggering event under §1.1503(d)-4(e)(1)(ii), which would require the recapture of the Year 1 dual consolidated loss (and an applicable interest charge). However, upon adequate documentation that the losses and deductions have expired for Country X purposes, P can rebut the presumption that a triggering event has occurred pursuant to §1.1503(d)-4(e)(2). Pursuant to §1.1503(d)-4(i)(1), if the triggering event presumption is rebutted, the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated loss of DRC_X is terminated and has no further effect (absent a rebuttal, the domestic use agreement would terminate pursuant to §1.1503(d)-4(i)(3)).

Example 44. Inability to rebut triggering event—tax basis carryover transaction. (i) *Facts.* (A) P owns DE1_X. DE1_X's sole asset is A, which it acquired at the beginning of Year 1 for \$100x. DE1_X does not have any liabilities. For U.S. tax purposes, DE1_X's tax basis in A at the beginning of Year 1 is \$100x and DE1_X's sole item of income, gain, deduction and loss for Year 1 is a \$20x depreciation deduction attributable to A. As a result, DE1_X's Year 1 \$20x depreciation deduction constitutes a dual consolidated loss attributable to P's interest in DE1_X. P makes a domestic use election with respect to DE1_X's Year 1 dual consolidated loss.

(B) For Country X tax purposes, DE1_X has a \$100x tax basis in A at the beginning of Year 1, but A is not a depreciable asset. As a result, DE1_X does not have any items of income, gain, deduction or loss in Year 1 for Country X tax purposes.

(C) At the beginning of Year 2, P sells its interest in DE1_X to F, an unrelated foreign person, for \$80x. P's disposition of its interest in DE1_X constitutes a presumptive triggering event under §1.1503(d)-4(e)(1) requiring the recapture of the \$20x dual consolidated loss (plus the applicable interest charge). For Country X tax purposes, DE1_X retains its tax basis of \$100x in A following the sale.

(ii) *Result.* The Year 1 dual consolidated loss is a result of the \$20x depreciation deduction attributable to A. Although no item of loss or deduction was recognized by DE1_X by the time of the sale for Country X tax purposes, the deduction composing the dual consolidated loss was retained by DE1_X after the sale in the form of tax basis in A. As a result, a portion of the dual consolidated loss may offset income for Country X purposes in a manner that would constitute a foreign use. For example, if DE1_X were to dispose of A, the amount of gain recognized by DE1_X would be reduced and, therefore, an item composing the dual consolidated loss would reduce foreign income of an owner of an interest in a hybrid entity that is not a separate unit. Thus, P cannot demonstrate pursuant to

§1.1503(d)-4(e)(2) that there can be no foreign use of the Year 1 dual consolidated loss following the triggering event and must recapture the Year 1 dual consolidated loss. Pursuant to §1.1503(d)-4(i)(3), the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated loss of DE1_X is terminated and has no further effect.

Example 45. Ability to rebut triggering event—taxable asset sale. (i) *Facts.* The facts are the same as *Example 44*, except that instead of P selling its interests in DE1_X to F, DE1_X sells asset A to F for \$80x. Such sale constitutes a presumptive triggering event under §1.1503(d)-4(e)(1). For Country X tax purposes, F's tax basis in A is \$80x.

(ii) *Result.* The Year 1 dual consolidated loss attributable to P's interest in DE1_X is a result of the \$20x depreciation deduction attributable to A. For Country X tax purposes, however, F's tax basis in A was not determined, in whole or in part, by reference to the basis of A in the hands of DE1_X. As a result, the deduction composing the dual consolidated loss will not give rise to an item of deduction or loss in the form of tax basis for Country X purposes (for example, when F disposes of A). Therefore, P may be able to demonstrate pursuant to §1.1503(d)-4(e)(2) that there can be no foreign use of the Year 1 dual consolidated loss and, thus, may not be required to recapture the Year 1 dual consolidated loss. Pursuant to §1.1503(d)-4(i)(1), if such a demonstration is made, the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated loss of DE1_X is terminated pursuant to §1.1503(d)-4(i)(1) and has no further effect (absent a rebuttal, the domestic use agreement would terminate pursuant to §1.1503(d)-4(i)(3)).

Example 46. Termination of consolidated group not a triggering event if acquirer files a new domestic use agreement. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. The P consolidated group uses the calendar year as its taxable year. In Year 1, DRC_X incurs a dual consolidated loss and P makes a domestic use election with respect to such loss. No member of the P consolidated group incurs a dual consolidated loss in Year 2. On December 31, Year 2, T, the parent of the T consolidated group acquires all the stock of P, and all the members of the P group, including DRC_X, become members of a consolidated group of which T is the common parent.

(ii) *Result.* (A) Under §1.1503(d)-4(f)(2)(ii)(B), the acquisition by T of the P consolidated group is not an event described in §1.1503(d)-4(e)(1) requiring the recapture of the Year 1 dual consolidated loss of DRC_X (and the payment of an interest charge), provided that the T consolidated group files a new domestic use agreement described in §1.1503(d)-4(f)(2)(iii)(A). If a new domestic use agreement is filed, then pursuant to §1.1503(d)-4(i)(2), the domestic use agreement filed

by the P consolidated group with respect to the Year 1 dual consolidated loss of DRC_X is terminated and has no further effect.

(iii) If a triggering event occurs on December 31, Year 3, the T consolidated group must recapture the dual consolidated loss that DRC_X incurred in Year 1 (and pay an interest charge), as provided in §1.1503(d)-4(h). Each member of the T consolidated group, including DRC_X and any former members of the P consolidated group, is severally liable for the additional tax (and the interest charge) due upon the recapture of the dual consolidated loss of DRC_X. In addition, pursuant to §1.1503(d)-4(i)(3), the new domestic use agreement filed by the T group with respect to the Year 1 dual consolidated loss of DRC_X is terminated and has no further effect.

Example 47. No triggering event if consolidated group remains in existence in connection with a reverse acquisition. (i) *Facts.* S owns FB_X. FB_X incurs a dual consolidated loss of \$100x in Year 1 and P makes a domestic use election with respect to such loss. At the end of Year 2, P merges into T, the common parent of the T consolidated group, which includes U as a member. The shareholders of P immediately before the merger, as a result of owning stock in P, own 60% of the fair market value of T's stock immediately after the merger.

(ii) *Result.* The P group is treated as continuing in existence under §1.1502-75(d)(3) with T and U being added as members of the P group, and T taking the place of P as the common parent. The merger of P into T does not constitute a triggering event with respect to the dual consolidated loss in Year 1 pursuant to §1.1503(d)-4(e)(1)(ii) because the P consolidated group, which owned FB_X, continues to exist.

Example 48. Triggering event exception—acquisition of assets by domestic owner. (i) *Facts.* P owns DE1_X. In Year 1, DE1_X incurs a loss of \$100x and, as a result, P's interest in DE1_X has a Year 1 dual consolidated loss of \$100x. P makes a domestic use election with respect to the Year 1 dual consolidated loss and such loss therefore is included in the computation of the P group's consolidated taxable income. In Year 3, DE1_X dissolves and surrenders its Country X corporate charter. Pursuant to its dissolution, DE1_X distributes its assets and liabilities to P and the shares of DE1_X are cancelled.

(ii) *Result.* The disposition of the assets of DE1_X (and the disposition of P's interest in DE1_X) as a result of the dissolution generally would be a triggering event under §1.1503(d)-4(e)(1). However, because the assets of DE1_X are acquired by P, its domestic owner, as a result of the dissolution, the dissolution does not constitute a triggering event under §1.1503(d)-4(f)(1).

Example 49. Subsequent elector rules. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. The P consolidated group uses the calendar year as its

taxable year. In Year 1, DRC_X incurs a dual consolidated loss and P makes a domestic use election with respect to such loss. No member of the P consolidated group incurs a dual consolidated loss in Year 2. On December 31, Year 2, T, the parent of the T consolidated group that also uses the calendar year as its taxable year, acquires all the stock of DRC_X for cash.

(ii) *Result.* (A) Under §1.1503(d)-4(f)(2)(i)(A), the acquisition by T of DRC_X is not an event described in §1.1503(d)-4(e)(1) requiring the recapture of the Year 1 dual consolidated loss of DRC_X (and the payment of an interest charge), provided: (1) the T consolidated group files a new domestic use agreement described in §1.1503(d)-4(f)(2)(iii)(A) with respect to the Year 1 dual consolidated loss of DRC_X; and (2) the P consolidated group files a statement described in §1.1503(d)-4(f)(2)(iii)(B) with respect to the Year 1 dual consolidated loss of DRC_X. If these requirements are satisfied, then pursuant to §1.1503(d)-4(i)(2) the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated loss of DRC_X is terminated and has no further effect (if such requirements are not satisfied, the domestic use agreement would terminate pursuant to §1.1503(d)-4(i)(3)).

(B) Assume a triggering event occurs on December 31, Year 3, that requires recapture by the T consolidated group of the dual consolidated loss that DRC_X incurred in Year 1, as well as the payment of an interest charge, as provided in §1.1503(d)-4(h). In that case, each member of the T consolidated group, including DRC_X, is severally liable for the additional tax (and the interest charge) due upon the recapture of the Year 1 dual consolidated loss of DRC_X. The T consolidated group must prepare a statement that computes the recapture tax amount as provided under §1.1503(d)-4(h)(3)(iii). Pursuant to §1.1503(d)-4(h)(3)(iv)(A), the recapture tax amount is assessed as an income tax liability of the T consolidated group and is considered as having been properly assessed as an income tax liability of the P consolidated group. If the T consolidated group does not pay in full the income tax liability attributable to the recapture tax amount, the unpaid balance of such recapture tax amount may be collected from the P consolidated group in accordance with the provisions of §1.1503(d)-4(h)(3)(iv)(B). Pursuant to §1.1503(d)-4(i)(3), the new domestic use agreement filed by the T consolidated group is terminated and has no further effect.

Example 50. Character and source of recapture income. (i) *Facts.* (A) P owns DE1_X. In Year 1, the items of income, gain, deduction, and loss that are attributable to P's interest in DE1_X for purposes of determining whether such interest has a dual consolidated loss are as follows:

| | |
|------------------------|---------|
| Sales income | \$100x |
| Salary expense | (\$75x) |
| Interest expense | (\$50x) |
| Dual consolidated loss | (\$25x) |

(B) P makes a domestic use election with respect to the Year 1 dual consolidated loss attributable to P's interest in DE1_X and, thus, the \$25x dual con-

solidated loss is included in the computation of P's taxable income.

(C) Pursuant to §1.861-8, the \$75x of salary expense incurred by DE1_X is allocated and apportioned entirely to foreign source general limitation income.

Pursuant to §1.861-9T, \$25x of the \$50x interest expense attributable to DE1_X is allocated and apportioned to domestic source income, \$15x of such interest expense is allocated and apportioned to foreign source general limitation income, and the remaining \$10x of such interest expense is allocated and apportioned to foreign source passive income.

(D) During Year 2, DE1_X generates \$5x of income, an amount which the \$25x dual consolidated loss generated by DE1_X in Year 1 would have offset if such loss had been subject to the separate return limitation year restrictions as provided under §1.1503(d)-3(c)(3).

(E) At the beginning of Year 3, DE1_X undergoes a triggering event within the meaning of §1.1503(d)-4(e)(1). Pursuant to §1.1503(d)-4(h)(2)(i), P demonstrates, to the satisfaction of the Commissioner, that the \$5x generated by DE1_X in Year 2 qualifies to reduce the amount that P must recapture as a result of the triggering event.

(ii) *Result.* P must recapture and report as income \$20x (\$25x - \$5x) of DE1_X's Year 1 dual consolidated loss, plus applicable interest, on its Year 3 tax return. Pursuant to §1.1503(d)-4(h)(5), the recapture income is treated as ordinary income whose source and character (including section 904 separate limitation character) is determined by reference to the manner in which the recaptured items of expense or loss taken into account in calculating the dual consolidated loss were allocated and apportioned. Accordingly, P's \$20x of recapture income is characterized and sourced as follows: \$4x of domestic source income (($\$25x/\$125x$) x \$20x); \$14.4x of foreign source general limitation income (($\$75x + \$15x/\$125x$) x \$20x); and \$1.6x of foreign source passive income (($\$10x/\$125x$) x \$20x). Pursuant to §1.1503(d)-4(i)(3), the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated of DE1_X is terminated and has no further effect.

Example 51. Interest charge without recapture.

(i) *Facts.* P owns DE1_X. In Year 1, a dual consolidated loss of \$100x is attributable to P's interest in DE1_X. P makes a domestic use election with respect to the Year 1 dual consolidated loss and uses the loss to offset the P group's consolidated taxable income. DE1_X earns income of \$100x in Year 2. At the end of Year 2, DE1_X undergoes a triggering event within the meaning of §1.1503(d)-4(e)(1). P demonstrates, to the satisfaction of the Commissioner, that taking into the limitation of §1.1503(d)-3(c)(3) (modified SRLY limitation), the Year 1 \$100x dual consolidated loss would have been offset by the \$100x Year 2 income.

(ii) *Result.* There is no recapture of the Year 1 dual consolidated loss attributable to P's interest in DE1 because it is reduced to zero under §1.1503(d)-4(h)(2)(i). However, P is liable for one year of interest charge under §1.1503(d)-4(h)(1)(ii), even though P's recapture amount is zero. Pursuant to §1.1503(d)-4(i)(3), the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated of DE1_X is terminated and has no further effect.

Example 52. Reduced recapture and interest charge, and reconstituted dual consolidated loss. (i) *Facts.* P owns DRC_X, a member of the P consolidated group. In Year 1, DRC_X incurs a dual consolidated loss of \$100x and P earns \$100x. P makes a do-

estic use election with respect to DRC_X's Year 1 dual consolidated loss. Therefore, the consolidated group is permitted to offset P's \$100x of income with DRC_X's \$100x loss. In Year 2, DRC_X earns \$30x, which is completely offset by a \$30x net operating loss incurred by P in Year 2. In Year 3, DRC_X earns income of \$25x, while P recognizes no income or loss. In addition, there is a triggering event at the end of Year 3.

(ii) *Result.* (A) Under the presumptive rule of §1.1503(d)-4(h)(1)(i), DRC_X must recapture \$100x. However, the \$100x recapture amount may be reduced by the amount by which the dual consolidated loss would have offset other taxable income if it had been subject to the limitation under §1.1503(d)-3(c)(3), upon adequate documentation of such offset under §1.1503(d)-4(h)(2)(i).

(B) Although DRC_X earned \$30x of income in Year 2, there was no consolidated taxable income in such year. As a result, the \$100x of recapture income cannot be reduced by the \$30x earned in Year 2, but such amount can be carried forward to subsequent taxable years and be used to the extent of consolidated taxable income generated in such years. In Year 3, DRC_X earns \$25x of income and the P consolidated group has \$25 of consolidated taxable income in such year. As a result, the \$100x of recapture income can be reduced by the \$25x. The \$30x generated in Year 2 cannot be used in Year 3 because there is insufficient consolidated taxable income in such year.

(C) Commencing in Year 4, the \$75x recapture amount (\$100x - \$25x) is reconstituted and treated as a loss incurred by DRC_X in a separate return limitation year, subject to the limitation under §1.1503(d)-2(b) (and therefore subject to the restrictions of §1.1503(d)-3(c)(3)). The carryover period of the loss, for purposes of section 172(b), will start from Year 1, when the dual consolidated loss was incurred. Pursuant to §1.1503(d)-4(i)(3), the domestic use agreement filed by the P consolidated group with respect to the Year 1 dual consolidated of DE1_X is terminated and has no further effect.

§1.1503(d)-6 Effective date.

Sections 1.1503(d)-1 through 1.1503(d)-5 shall apply to dual consolidated losses incurred in taxable years beginning after the date that these regulations are published as final regulations in the **Federal Register**.

Par. 4. In §1.6043-4T, paragraph (a)(1)(iii) is amended by removing the language “§1.1503-2(c)(2)” and adding “§1.1503(d)-1(b)(2)” in its place.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on May 19, 2005, 9:47 a.m., and published in the issue of the Federal Register for May 24, 2005, 70 FR. 29867)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations; Notice of Public Hearing; and Withdrawal of Previously Proposed Regulations

Credit for Increasing Research Activities

REG-134030-04 and REG-133791-02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations; notice of public hearing; and withdrawal of previously proposed regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9205) relating to the computation and allocation of the credit for increasing research activities for members of a controlled group of corporations, including consolidated groups, or a group of trades or businesses under common control. The text of those regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations and withdraws the proposed regulations published in the **Federal Register** on July 29, 2003 (68 FR 44499).

DATES: Written or electronic comments must be received by September 28, 2005. Requests to speak and outlines of the topics to be discussed at the public hearing scheduled for October 19, 2005, at 10 a.m. must be received by September 28, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-134030-04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-134030-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively,

taxpayers may submit electronic comments directly to the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-134030-04). The public hearing will be held in the Auditorium, 7th Floor, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Nicole R. Cimino at (202) 622-3120; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Robin R. Jones at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document withdraws the notice of proposed rulemaking (REG-133791-02, 2003-2 C.B. 493) published on July 29, 2003, and amends the Income Tax Regulations (26 CFR 1) relating to section 41. The temporary regulations set forth the rules relating to the computation and allocation of the credit for increasing research activities for members of a controlled group of corporations, including consolidated groups, or a group of trades or businesses under common control under section 41(f) for taxable years ending on or after May 24, 2005. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not

apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 19, 2005, beginning at 10 a.m. in the Auditorium, 7th Floor, of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 28, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Nicole R. Cimino, Office of the Associate Chief Counsel (Passthroughs and

Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-133791-02) published in the **Federal Register** on July 29, 2003, (68 FR 44499) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.41-6 also issued under 26 U.S.C. 41(f).* * *

Par. 2. In §1.41-0, the table of contents is amended as follows:

§1.41-0 Table of contents.

[The text of proposed §1.41-0 is the same as the text of §1.41-0 published elsewhere in this issue of the Bulletin].

Par. 3. Section 1.41-6 is revised to read as follows:

§1.41-6 Aggregation of expenditures.

[The text of proposed §1.41-6 is the same as the text of §1.41-6T published elsewhere in this issue of the Bulletin].

Par. 4. Section 1.41-8 is revised to read as follows:

§1.41-8 Special rules for taxable years ending on or after January 3, 2001.

[The text of proposed §1.41-8 is the same as the text of §1.41-8T published elsewhere in this issue of the Bulletin].

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Information Returns by Donees Relating to Qualified Intellectual Property Contributions

REG-158138-04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document contains proposed regulations that provide guidance for the filing of information returns by donees relating to qualified intellectual property contributions. The text of the temporary regulations (T.D. 9206) published in this issue of the Bulletin also serves as the text of these proposed regulations. The regulations affect donees receiving qualified intellectual property contributions after June 3, 2004.

DATES: Written or electronic comments and requests for a public hearing must be received by August 22, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-158138-04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-158138-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs, or via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-158138-04). A public hearing may be scheduled if requested by any person who timely submits comments.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Donnell M. Rini-Swyers, (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by July 22, 2005. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in this proposed regulation are in 1.6050L-2. Section 6050L(b) requires certain donees of qualified intellectual property to annually report certain information regarding the qualified intellectual property to the In-

ternal Revenue Service and to provide the information to the donor of the qualified intellectual property. Section 1.6050L-2 provides guidance for the filing of information returns by donees relating to qualified intellectual property contributions. These collections of information are required to obtain a tax benefit. The likely respondents are tax-exempt organizations.

Estimated total annual reporting and/or recordkeeping burden: 200 hours. Estimated average annual burden per respondent and/or recordkeeper is two hours.

Estimated number respondents and/or recordkeepers: 100.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 6050L. The temporary regulations provide guidance for filing information returns by donees relating to qualified intellectual property contributions.

This document contains proposed Income Tax Regulations under the American Jobs Creation Act of 2004 (Public Law 108-357, 118 Stat. 1418) (the Act). They are necessary to implement section 882 of that Act, which directs that regulations be issued regarding information returns by donees relating to qualified intellectual property contributions made after June 3, 2004.

The Act provides rules that enable taxpayers who donate qualified intellectual property to receive additional charitable contribution deductions if and when their donated property produces net income for the donee (qualified donee income), under specified conditions. Section 170(m)(2), (8), (9). Under the Act, a taxpayer who contributes a "patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark,

trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property,” to a donee described in section 170(c) (other than to a private foundation referred to in section 170(e)(1)(B)(ii)) may be allowed an initial charitable contribution deduction limited to the lesser of the taxpayer’s basis or the fair market value of the qualified intellectual property. In addition, the taxpayer may be permitted to deduct certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received by the donee with respect to the qualified intellectual property.

Section 882(c)(1) of the Act amended section 6050L to require donees to make an annual information return that reports the qualified donee income for the taxable year and other specified information relating to qualified intellectual property contributions. The IRS expects to issue a new Form 8899 on which donees will report qualified donee income.

Under section 170(m)(8)(B), a donor must notify the donee of the donor’s intent to treat a charitable contribution as a qualified intellectual property contribution under sections 170(m) and 6050L. For rules relating to donor notification, see section 170(m)(8)(B) and Notice 2005–41, 2005–23 I.R.B. 1203, issued thereunder. Unless timely notice is provided, the donor has not made a qualified intellectual property contribution, and the donee has no reporting obligation under section 6050L or these regulations.

The donee is not required to make an information return if the qualified intellectual property produced no net income for the donee’s taxable year. Under section 170(m)(5) and (m)(6), income received or accrued during the donee’s taxable year is not treated as allocated to qualified intellectual property if such income is received or accrued after the 10-year period beginning on the date of the contribution or after the expiration of the legal life of the qualified intellectual property. Thus, the donee is not required to make a return with regard to a qualified intellectual property contribution for taxable years

beginning after the expiration of the legal life of such qualified intellectual property. Additionally, section 6050L(b) requires a return only for specified taxable years of the donee, which years are defined in section 6050L(b)(2)(B) as any taxable year any portion of which is part of the 10-year period beginning on the date of contribution of the qualified intellectual property. Therefore, the donee is not required to make a return for taxable years beginning more than 10 years after the date of the qualified intellectual property contribution.

Under these regulations, the donee generally is required to file an information return (with a copy of such return to the donor) on or before the last day of the first full month following the close of the donee’s taxable year. See section 7701(a)(23) for the definition of taxable year. Transition rules are provided to take into account these filing requirements before a form is prescribed by the Internal Revenue Service and for donees’ taxable years ending prior to or on the date of issuance of these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few, if any, small entities will be required to file under these regulations. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed

original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Donnell M. Rini-Swyers, Office of Assistant Chief Counsel (Procedure & Administration).

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6050L–2 is added to read as follows:

§1.6050L–2 Information returns by donees relating to qualified intellectual property contributions.

[The text of §1.6050L–2 is the same as the text of §1.6050L–2T published elsewhere in this issue of the Bulletin].

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 23, 2005, 70 F.R. 29460)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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